BANK OF ENGLAND

Speech

Ten good reasons to tighten

Speech given by

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I would like to thank Tomasz Wieladek and Adrian Chiu 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.

The minutes of the latest meeting of the Monetary Policy Committee of the Bank of England, released earlier this week, highlight the differences of opinion which currently exist within the Committee. Among the nine members of the Committee, there are four different policy positions – ranging from my support for a 0.5% rise in Bank Rate to a £50bn injection of further Quantitative Easing advocated by my colleague Adam Posen. I cannot recall a time when the Committee has split four ways in terms of its policy judgement before. And this highlights the unusual situation in which we find ourselves in the UK economy.

We have passed through a major recession, driven by a global financial crisis. Recessions are expected to push down inflation, and yet inflation has gone up. The forces that are driving higher inflation are partly global in nature and some of the influences may prove temporary, such as the impact of the recent rise in VAT. But there are other elements which may endure and threaten to raise inflation over the medium-term, including the very large drop in the external value of the pound we have seen since mid-2007.

Because there are a number of factors contributing to the recent surge in inflation, it is perhaps not surprising that there is some disagreement about how to respond to it. Since last summer, I have been arguing that we should be raising interest rates to help to limit the rise in inflation and bring it back to target.

I am pleased to see this view gaining ground in the Committee. Though a rise in interest rates would not be popular in some quarters, I believe it is necessary to maintain stable monetary conditions here in the UK and ensure inflation does come back to target after a long period when it has run at a relatively high level.
The framework within which the MPC operates aims to promote the longer-term health of the nation by ensuring that economic growth and employment are built on a solid foundation of low and stable inflation. Solid economic growth is not built on a platform of easy money, as we have discovered in the wake of the financial crisis. It is built on enterprise, innovation, investment and a skilled and productive workforce. The job of monetary policy is to foster a sufficiently stable economic climate so these underlying forces of growth can flourish and create economic value which can be sustained over the longer term. Unless that is the case, the recovery will turn out to be a "flash in the pan".

In late 2008 and in 2009, it was quite right for monetary authorities to relax policy to limit the damage from the giant wrecking ball of the financial crisis which was wreaking havoc in the global economy. But the balance of economic forces across the world economy and here in the UK has shifted significantly since then. Demand is now recovering at home and abroad – quite strongly in some areas, and inflation is now a much bigger worry than deflation.

It is against this background that I have made my arguments for higher interest rates – not interest rate "hikes" but a controlled move upwards from the exceptionally low level we reached in 2009. Until this month, I thought we should be gradually moving the official Bank Rate up in quarter point steps from its current level of 0.5%. As the minutes from the February MPC make clear, I now think that a half a percentage point rise would now be a more appropriate first move. But even this would leave the official UK interest rate at one percent in the short-term – a very low level historically and in line with our main trading partner in the euro area.

Tonight, I feel that the most helpful contribution I can make to the debate would be to recap the arguments as I see them for the policy I have been supporting for nearly nine months now. So here are "Ten Good Reasons to Tighten" monetary policy here in the UK – not to spoil the economic party but to put our future prosperity on a sound footing.

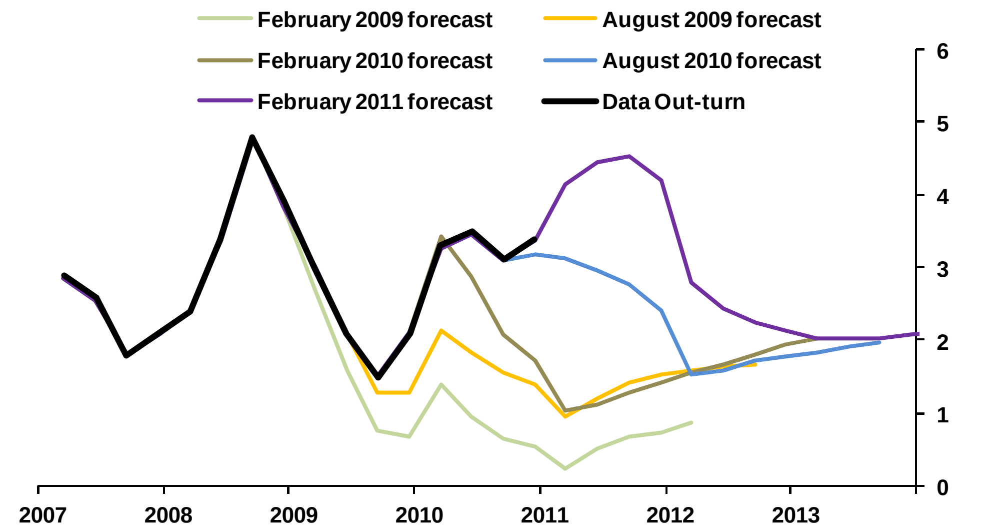
Reason 1: UK inflation

It makes sense to start with UK inflation. The MPC is accountable through its mandate to keep consumer price inflation at 2%. The mandate acknowledges that fluctuations will take place due to factors outside the MPC's control. However, such factors causing deviations of inflation from target might be expected to be temporary rather than persistent. That has not been our experience, though. Inflation has been above target for most of the time I have been on the MPC and some of the upward deviations have been quite significant. This creates a much stronger platform for tightening monetary policy than if we had experienced simply a "one-off blip" in inflation.

The average CPI inflation rate while I have been on the MPC – since October 2006 – has been around 3% and over the past three years it has averaged 3.5%. In January it was 4.0%. In addition, CPI inflation is expected to rise higher in the short-term before falling back. Indeed, since 2009, when the MPC put in place the current policy settings, inflation has persistently run ahead of the official forecasts set out in the Bank of England *Inflation Report*, as Chart 1 shows.

Chart 1 – *Inflation Report* forecasts

Mean of forecast percentage annual increase in consumer prices



Source: Bank of England

In my speech last week, I set out some arguments why I believe this has been the case. In my view, the *Inflation Report* forecasts have persistently overstated the depressing impact that spare capacity in the UK economy might have on UK inflation, while understating the potential inflationary influences from the global economy, recovering demand and the very accommodative stance of monetary policy. In my view, therefore, the current risks to the inflation outlook are to the upside of the latest forecasts in the February *Inflation Report*.

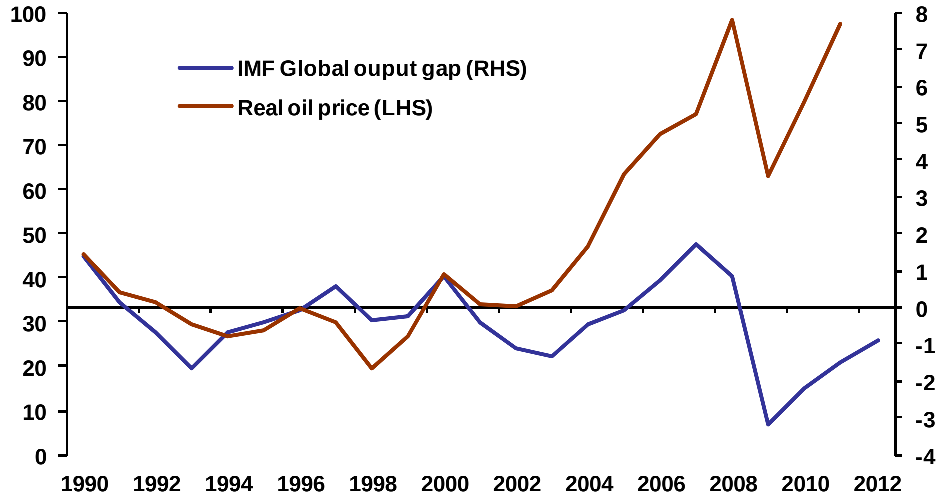
It is sometimes argued that because the causes of high inflation are not totally within the MPC's control, then it would be wrong for the MPC to lean too heavily against these external factors. I have some sympathy with this argument, in that we might expect inflation to fluctuate to some degree with changes in the global climate. What I find harder to accept is that there should be no policy response from the MPC in the current environment when inflation is so significantly and persistently above target and is expected to remain so for some time. It may be unrealistic to hope to eradicate a tide of global inflation. But that does not mean we should not lean against it to some degree and try and limit is impact using the tools of monetary policy.

Reason 2: Global inflationary pressures

If we could be confident that global inflationary pressures would quickly subside, then we might be more comfortable about not adjusting policy in response to them. But we cannot be confident that the current drivers of global inflation will quickly fall back. The upward pressure on global energy and commodity prices shows little sign of abating. The price of Brent crude has moved quickly above $100/barrel this year, and the stable relationship which existed before 2000 between global capacity pressures and the real oil price has shifted dramatically as Chart 2 shows.[1] Other commodity prices have responded similarly to the pressure of global demand, such as the cotton price which has recently reached its highest ever level. The most recent example has been the coffee price which has just hit its highest level for fourteen years – which is a level of prices which has not been sustained since the mid-1970s.

Chart 2 – Real oil prices and global output gap

Price of Brent Crude deflated by US final consumption deflator



Note: Output gap as percentage of potential output. Price of Brent Crude for 2011 is the year-to-date average.

Source: IMF and Thompson Datastream.

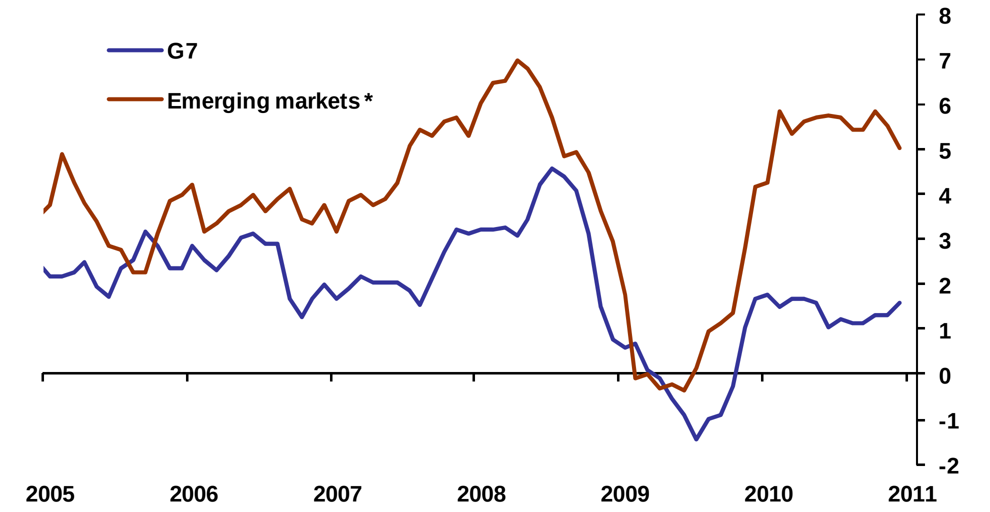
A key driver of these rises in energy and commodity prices we have seen in the past decade has been strong demand driven by growth in Asia and other emerging markets. With this strong growth projected to continue through this year and next at least, it seems unlikely to me that these global inflationary pressures would quickly subside.

In addition, there may be further knock-on effects from this recent wave of global inflation. The previous strong surge in oil and commodity price inflation we saw in 2008 was damped down by the depressing impact of the global financial crisis. This helped prevent inflation becoming more ingrained in the emerging market economies which have been driving demand across the global economy. A more sustained period of inflation in Asia and other emerging market economies therefore appears to be a bigger risk now than in 2008. Chart 3 shows that in the six largest emerging market economies, inflation is already running at a high level, which may exert further upward pressure on wages and the cost of goods exported to the West. With inflation also creeping up in mature industrialised economies like the UK, it may prove much harder to dampen this wave of global inflationary pressure this time round.

[1] Over the course of today, 24 February 2011, Brent crude was trading at over $110 per barrel

Chart 3 – Global CPI inflation

Percentage annual increase in consumer prices



* Emerging market economies include Brazil, China, India, Indonesia, Russia and South Korea. Averages of CPI inflation are taken using real GDP as weights.

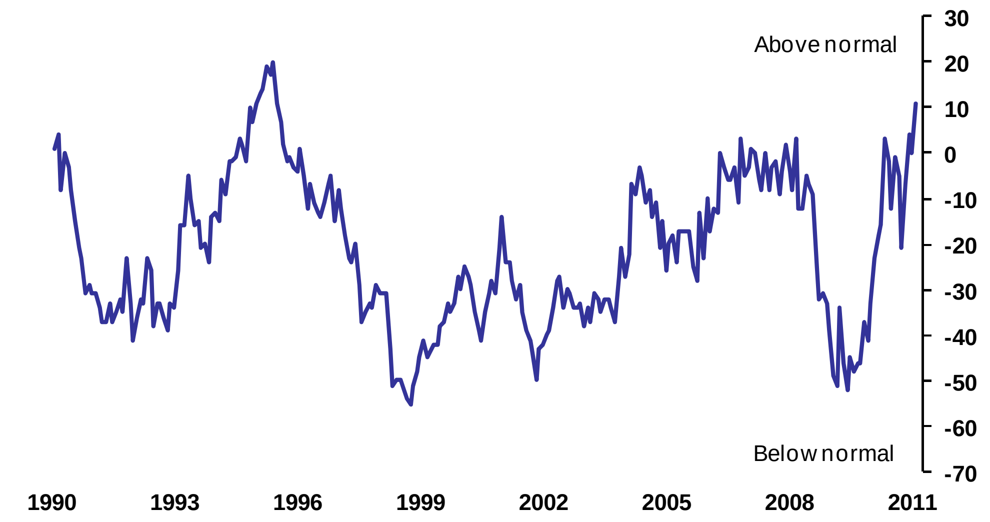
Source: OECD Main Economic Indicators, IMF World Economic Outlook and Thompson Datastream.

Reason 3: Global demand

Global demand pressures are helping to fuel inflation on world markets at present. But that is not the only impact that they have on the UK economy. First, global demand boosts the growth of many sectors in the UK economy, both directly and indirectly. The most obvious example of this is the manufacturing sector of the economy. As Chart 4 shows, the CBI monthly survey of manufacturing export order books hit a 15-year high this month, and this is a reflection of the strength of demand across the global economy, reinforced by a very competitive level of sterling. However, manufacturing is not the only sector of the UK economy to benefit from strong global demand. Financial and business services, air transport, telecommunications and many other services which are traded internationally can also benefit when global demand is strong.

Chart 4 – Export order book volumes

Balance of manufacturers reporting above normal export order books



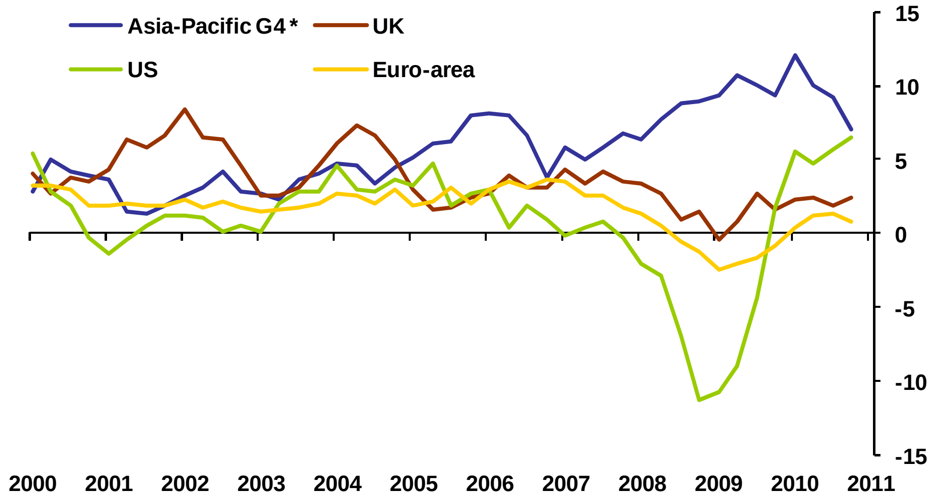
Source: CBI Monthly Trends Enquiry

Why is global demand so strong when many economies have been reeling from the shocks created by the financial crisis in 2008? Chart 5 shows trends in retail spending in the Asia-Pacific region compared with the larger western economies. Domestic demand in Asia was particularly important in supporting the growth of the world economy through the downturn in 2008 and early 2009. Going into the financial crisis, there was a certain amount of scepticism about the ability of Asian economies to expand domestic demand to sustain growth, but these fears have hopefully been allayed by the experience of the past few years. Chart 5 also shows that domestic demand is now recovering quite strongly in the US and to a lesser extent in the UK and other European economies, supported by stimulatory policies and a recovery in confidence. A continuation of this recovery in the advanced economies of the West and continuing robust growth in the emerging market economies in Asia and elsewhere is likely to mean strong growth across the world economy as a whole. And that is broadly what current forecasts for the global economy produced by the IMF and others are suggesting.[2]

[2] In its January update, the IMF projected 4.4% growth in world output in 2011 and 4.5% growth in 2012 after 5.0% growth this year. This is a return to the strong growth rates experienced in the mid-2000s.

Chart 5 – Global retail sales growth

Percentage annual increase in sales volumes



* 'Asia-Pacific G4' includes Australia, China, Japan and South Korea.

Source: OECD Main Economic Indicators and Thompson Datastream.

Reason 4: UK demand and growth

Strong world demand and global inflationary pressures would not have had such a significant impact on UK inflation, however, if there had not also been a turnaround in the UK domestic demand climate since 2009. When demand is falling sharply, as it was in the UK from mid-2008 to mid-2009, this creates a business environment in which companies are under pressure to cut prices or are struggling to increase them. When demand growth recovers and starts growing healthily again, businesses may well want to recoup price cuts made in more difficult times and recover cost increases they have not been able to pass through in the recession. A recovery in domestic demand is therefore potentially an environment in which inflationary pressures can emerge and this is a risk that monetary authorities need to be alert to.

I have pointed out on a number of occasions now that UK domestic spending recovered strongly both in real and nominal terms in between the middle of 2009 and the middle of 2010.[3] But there have been concerns about the extent to which this recovery in demand growth would be sustained. The initial estimate of GDP growth in the fourth quarter played into these concerns. Even though the ONS acknowledged that growth had been heavily snow-affected, their statement that underlying growth had been "flattish" added to concerns that UK growth may have been slowing in the second half of last year. Aside from the obvious impact of the weather, I think these concerns have been misplaced for two reasons.

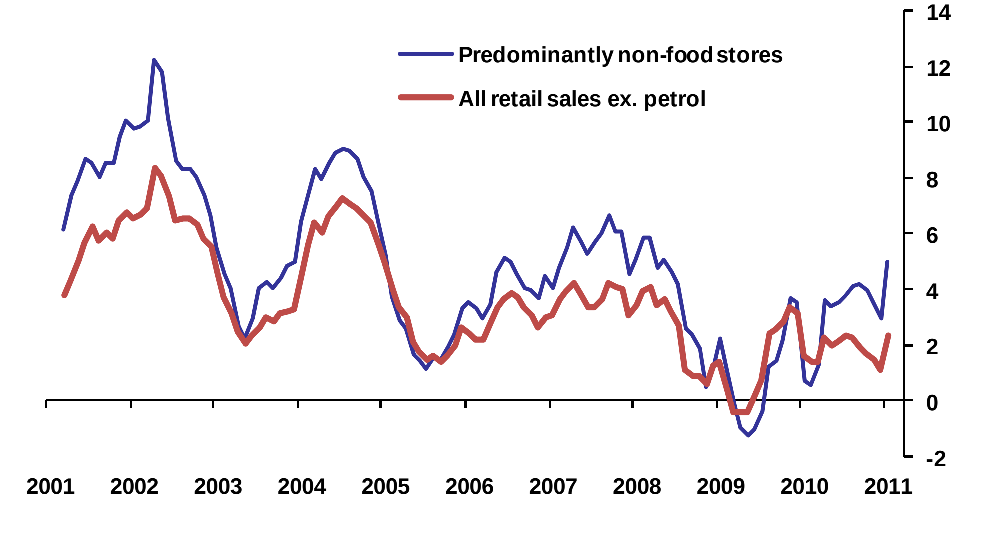
[3] In the year to the third quarter of 2010, domestic expenditure rose 6.8% in money terms and 3.7% in real terms – in both cases considerably above average growth rates since the early 1990s.

First, GDP growth in the middle of 2010 was unusually strong. In the second and third quarters of last year we saw the strongest two consecutive quarters of growth in the UK economy for over six years.[4] Some slowdown in the momentum of activity from this rather hectic growth rate, which was also accompanied by strong employment growth, was probably to be expected.

Second, indicators of growth that we have seen since the December snow have generally been positive. These include the regular Purchasing Managers' Surveys for January – which showed record growth in manufacturing and reasonably healthy growth in services – together with the CBI's Monthly Trends survey of manufacturing and the most recent retail sales figures, which are shown in Chart 6.

Chart 6 – UK retail sales volumes

Annual growth: three months compared to previous year



Source: ONS

Monthly retail sales volumes have been affected by both weather and VAT rises during this winter and last winter. But if we take a three-month moving average and compare it to a year ago, we are comparing like with like, periods which are affected by both snowy weather (in January 2010 and December 2010) and a VAT rise. As Chart 6 shows, on this basis retail sales growth excluding petrol is up by just over 2% and is continuing at a similar growth rate to the trend we have seen since the middle of last year. Indeed, non-food retail sales, which might be seen as more discretionary have been accelerating in recent months and their year-on-year growth is back to pre-recession levels.

Clearly some caution about the pace of UK growth is appropriate at present. Recent CBI surveys of retail sales and consumer services show a more downbeat picture. But while there are clearly headwinds to the demand climate in the UK from fiscal tightening, the recovery in the UK domestic economy does appear to

4 GDP grew by 1.85% in Q2 and Q3 2010, compared with 1.89% in Q4 2003 and Q1 2004. The previous period of sustained growth stronger than this was in 1999 and early 2000.

be continuing. Though we should expect to see fluctuations in the rate of growth as the recovery proceeds, most of the indicators from the early part of this year point to a resilient economy, especially if we allow for the impact of the VAT rise coming into effect last month.

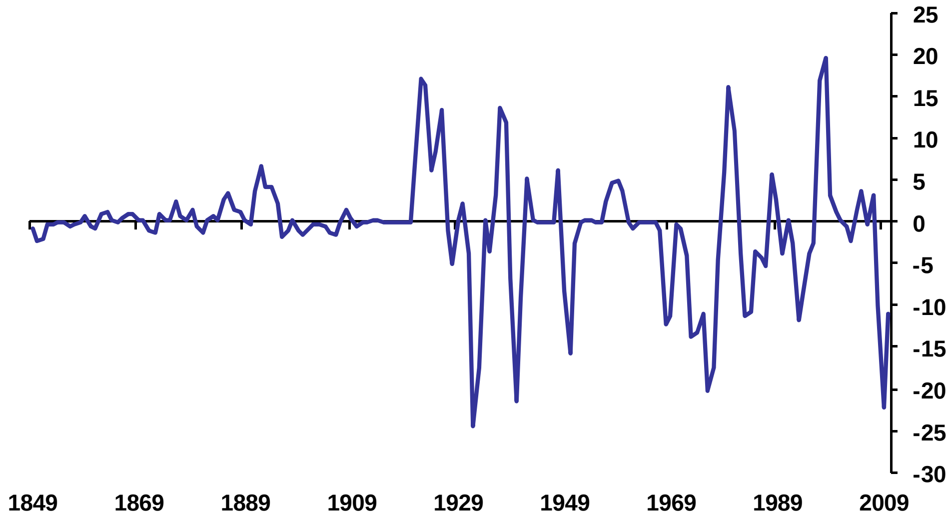
Reason 5: The depreciation of sterling

Going beyond growth and inflation at home and abroad, my fifth reason for tighter monetary policy is to act as a counterweight to the current weakness of sterling. In my speech last week,[5] I drew attention to the role of the pound in fuelling recent UK inflationary pressures. And I highlighted the risks attached to allowing a period of prolonged currency weakness when we were also facing major global inflationary pressures. I readily acknowledge that the pound may have weakened to some degree in response to the structural effects of the financial crisis on the UK economy. But the depreciation is historically so large, that there must be a risk that it has been reinforced by the very substantial loosening of monetary policy and that upward pressure on import prices will continue to complicate our task of getting inflation back to target.
Chart 7 supports this view. It shows movements in a measure of the nominal sterling effective exchange rate, against a trade-weighted basket of currencies. The dominant elements of this basket are the value of sterling against the US dollar and other European currencies – as Europe and the US are our major trading partners. As Chart 7 shows, over the two years 2008 and 2009, the pound fell by 22.3% against this trade-weighted basket. There has only been one larger two-year decline in the value of the pound against other currencies – after the UK left the gold standard in 1931.[6] We saw a more persistent depreciation in the mid-1970s, but given the inflation experience of the UK over that period, this is a not perhaps an example we would want to follow.

[5] Sentance (2011b)
[6] Based on nominal effective exchange rate data from Dimsdale et al (2010), the biggest sterling depreciation over a two year period since 1847 is 24.5% which occurred following the 1931 devaluation. This compares to the 22.3% depreciation over a two year period in 2007 to 2009. Though there was a large depreciation against the dollar in 1949, the moves against a broader basket of currencies were not as large, as many currencies linked to sterling experienced depreciations of similar magnitudes against the dollar at the time. Data supplied by Jim Lothian (see Lothian an Taylor, 1996) further corroborates this result and confirms that there were no larger depreciations as far back as 1803.

Chart 7 – Sterling effective exchange rate since 1849

Percentage nominal appreciation (depreciation) over two year periods



Source: Dimsdale, Hills and Thomas (2010) and Bank calculations.

It is widely acknowledged that many of the inflationary pressures affecting the UK economy are associated with higher import prices. But when these higher import prices also reflect a decline in the value of our own currency, we should not treat them as totally beyond the control of domestic policy-makers. Monetary policy can affect the value of the pound through the effect of actual and expected interest rates on the views of foreign exchange dealers. Since 2007, the pound has fallen further than in previous episodes when the economy was rebalancing – such as the 1990s. There is therefore a risk that the depreciation is not only helping the economy to rebalance, but also aggravating underlying inflationary pressures at the same time.

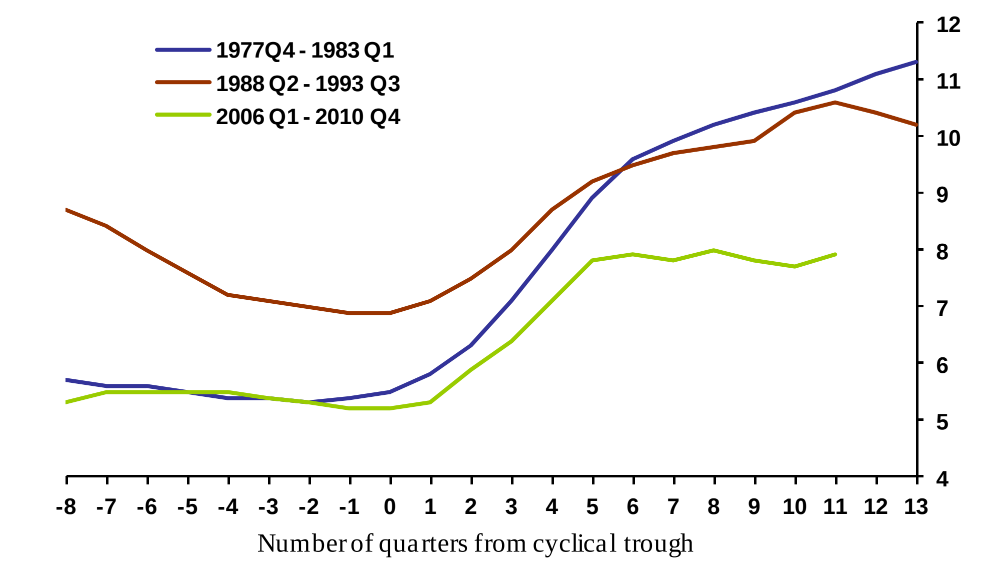
Reason 6: Spare capacity and the labour market

In the latest *Inflation Report* forecast, published last week, many of the factors I have discussed so far are expected to keep up inflation in the short-term. But their influence is expected to subside as time passes. I am less confident than some others on the Committee that this will be so, given the momentum of global growth and the potential for it to generate further inflationary pressure on world markets. The other area where I depart company from the analysis in the *Inflation Report* is the impact on inflation of spare capacity in the economy. Since the recession, the margin of spare capacity has not exerted much downward pressure on inflation so far, and I am sceptical that we will see more evidence in a year or two's time when the recession is a more distant memory and the recovery is better established.

I discussed this issue in more detail in my speech last week, and I drew attention to the fact that surveys of spare capacity in businesses are much closer to normal than you might have expected in the wake of a severe recession.[7] The other aspect of spare capacity is the amount of slack in the labour market and the way in which it might be holding back wage growth. As Chart 8 shows, the level of unemployment generated by this recession is lower than in the early 1980s and early 1990s. This is something we should be very thankful for, given the damage that unemployment does to individual lives and communities. But in terms of inflation, it means we should expect much less of a dampening impact on wage increases and inflation as the economy recovers and labour demand picks up.

Chart 8 – UK unemployment rate

Numbers unemployed as a percentage of economically active population



Source: ONS Labour Force Survey

At the same time, we are expecting high headline inflation, which is likely to act as a potential upward influence on pay settlements. So while I am not expecting a serious explosion in wage settlements, I would expect them to return quite quickly to their pre-recession levels, supported by the persistence of high headline inflation and the desire of companies to reward employees who may have sacrificed pay increases in past years to help their businesses through the recession.

So both in terms of the spare capacity within firms and from the labour market, I am not expecting to see much dampening of inflation from capacity pressures looking ahead. And this increases the risk that inflation will continue to run above target for some of the other reasons I have already discussed.

[7] See Sentance (2011a) and (2011b).

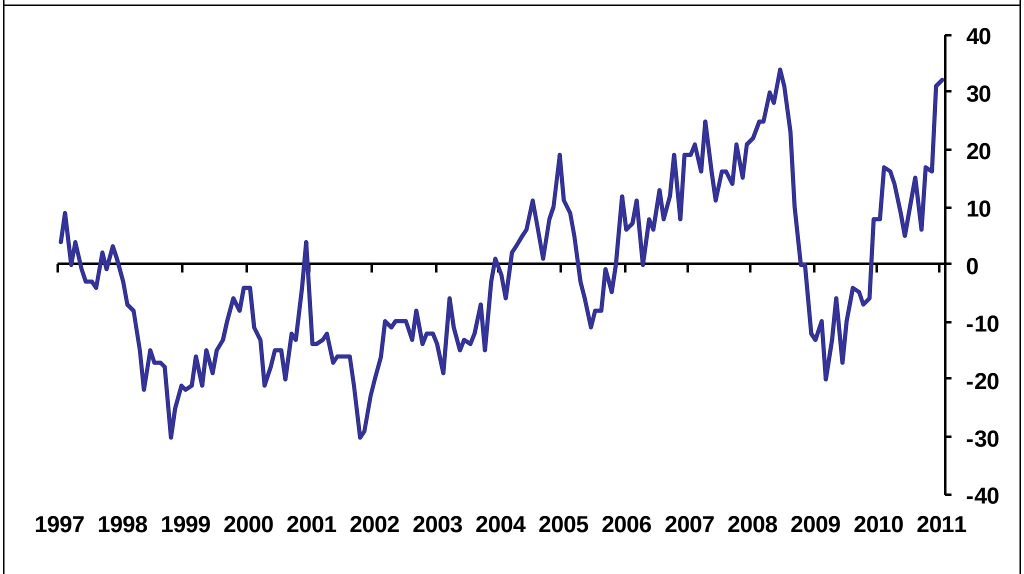
Reason 7: The pricing climate

My seventh reason for supporting a tightening of UK monetary policy is the pricing climate that has been created in the wake of the recession. We have seen some unprecedented moves to relax monetary policy here in the UK – taking interest rates down to a record low level and accommodating a very sharp depreciation in the pound. The way in which monetary policy has operated in the recent recession has sent very different signals to the private sector compared with the previous recessions in the early 1980s and early 1990s. In these earlier recessions, tight monetary policy reinforced the message that businesses needed to grind down cost and price increases because inflation was too high and needed to be ratcheted downwards. By contrast, in the recent recession, monetary policy settings have been very stimulatory to ward off the risk of deflation.

We saw in late 2009 and early 2010 beneficial effects from sending out these supportive signals. Deflation was averted. The recession turned around and growth resumed. But since then, a more worrying pattern seems to have emerged. Companies appear to be more willing and able to pass through cost increases than in the past. Retailers are expected to pass through close to the full amount of the VAT increase introduced this year. And manufacturers appear to be expecting to pass through the cost increases they are experiencing currently, as the price expectations from the CBI survey shown in Chart 9 indicate.

Chart 9 – Manufacturing price expectations

Balance of respondents expecting increases in average domestic prices



Source: CBI Monthly Trends Enquiry

To me, this is not yet an indication that longer-term price expectations have moved upwards and that businesses have totally lost confidence in the inflation target. If that was the case, we would be in a very worrying and serious position indeed. But it is a warning signal that the private sector is beginning to perceive a different pricing climate from the past, and that over a period of time they may interpret this as a signal that there has been a more permanent shift towards a higher inflation world. Before this happens, it is essential that monetary policy starts to send a contrary signal. We should demonstrate we are prepared to restrain demand and possibly see the pound rise somewhat to help bring down inflation. If that signal is not sent, even in a mild form, through a gradual rise in interest rates, there is a risk that the change in the pricing climate is perceived as permanent, not temporary.

Reason 8: Credibility of monetary policy

This issue of the pricing climate and price expectations is closely linked to the need to maintain the credibility of monetary policy. In the UK, the credibility which surrounds the Bank of England and its commitment to the inflation target is hard-won. After inflation rose to over 25% in the mid-1970s,[8] it took three recessions and nearly twenty-five years before it was properly subdued and the economy was once again operating at a sustained high level of employment. I do not think we are at any risk of a return to the bad old days of the 1970s. Notwithstanding my affection for the rock music of the seventies, the economic turmoil of that period is definitely not something we want to revisit.

But one of the lessons from the battles against inflation in the 1970s and the 1980s, was the importance of having credible policies. Statements about the need to reduce inflation need to be backed up by actions to achieve that objective. If that is not the case, the statements made by policy-makers about their economic objectives begin to lack credibility.

The MPC is starting from a strong position in that it presided over a decade of low inflation from 1997 and 2007. And as I have travelled around the country visiting businesses, there is strong support for the monetary framework currently in place and its emphasis on low and stable inflation. But even on the basis of the published forecasts in the *Inflation Report*, there is a clear indication that the inflation outlook is deteriorating. In addition to the prospect of inflation running at 4 per cent or above throughout this year, CPI inflation two years ahead on unchanged policy assumptions is now further above the target than at any time since February 1998, when the MPC was raising rates aggressively.[9] This is signalling the risk that without policy action, inflation will be significantly above target in the medium-term and that some tightening of policy will be needed to return it to the 2% target level. In my view, it is better to take this action sooner rather than later as I see even greater upside risks to inflation than are recognised in the *Inflation Report* forecast.

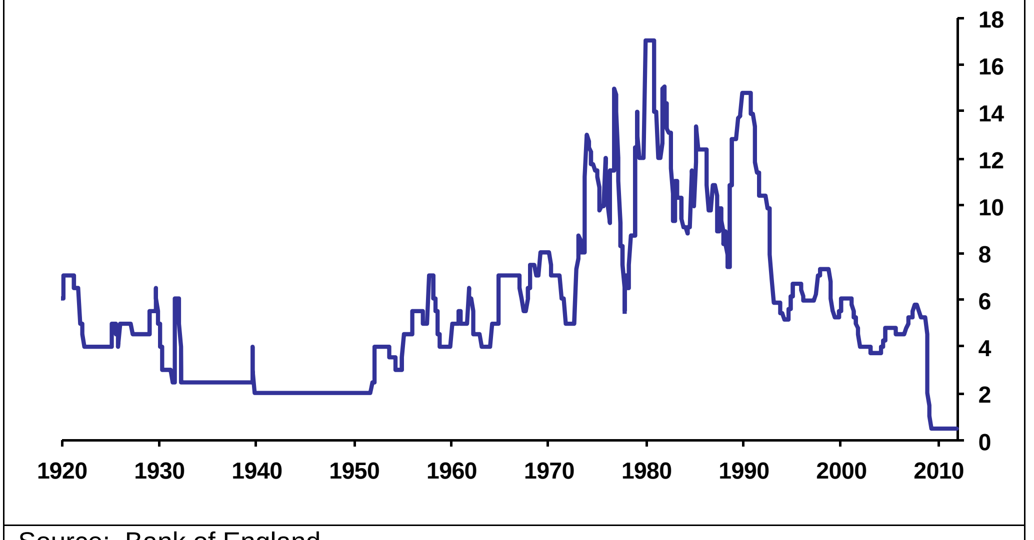
[8] RPI inflation was above 25% between May and November 1975 and reached a peak of 26.9% in August 1975.
[9] The mean forecast for CPI inflation two years ahead is 2.48%, on the assumption of unchanged Bank Rate at 0.5%. In February 1998, the two-year ahead forecast was 3.03% for RPIX inflation relative to a target of 2.5%, on the assumption of unchanged Bank Rate at 7.25%. I am grateful for Simon Ward, of Henderson Global Investors, for pointing this out.

Reasons 9 and 10: Record low interest rates and gradual tightening

I have so far given eight reasons for tightening UK monetary policy. Let me recap them, and mention the final two. The eight reasons I have cited so far are the persistence of high UK inflation, global inflationary pressures, strong global demand, recovery in UK growth and demand, the weakness of the pound, the weak impact of spare capacity on inflation, signs of an inflationary shift in the pricing climate for business, and the need to back up words with actions and maintain the credibility of UK monetary policy.

My final two reasons relate to the very low level of interest rates we are starting from and the desirability of a gradual shift away from this low level if it can be achieved. Chart 10 shows UK interest rates since 1920. Not only do we have the lowest level of official Bank Rate in the history of the Bank of England, but interest rates have been sustained at this low level for the longest period since the 1930s and 1940s when Bank Rate was kept at 2% through the Great Depression, the Second World War and into the early 1950s. That was an exceptional and unusual period, and yet the official Bank Rate was not reduced then as low as it has been recently. Broader measures of monetary conditions, such as the index shown in Chart 11, which takes into account the value of the pound and longer term interest rates, highlight the same point.[10]

Chart 10 – United Kingdom Bank Rate since 1920

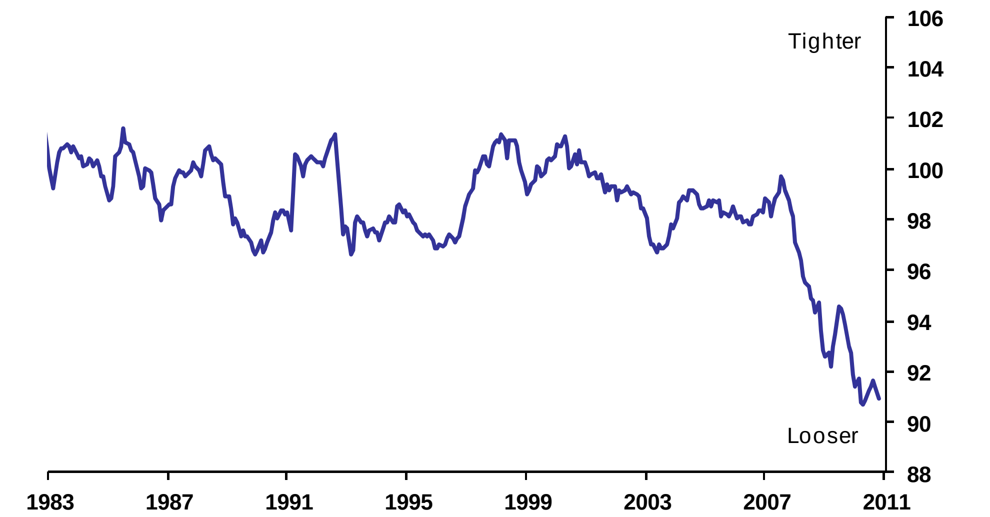


Source: Bank of England

[10] The Monetary Conditions Index shown in Chart 11 is calculated using the approach proposed by Walton and Massone (1999). For a broader discussion of this index and other similar measures, see Batini and Turnbull (2000).

Chart 11 – Monetary condition index for the UK

Index, 1983=100



Note: Calculated according to Walton and Massone (1999), as surveyed by Batini and Turnbull (2000).

Source: Bank calculations

Monetary conditions were relaxed very dramatically to deal with the exceptional conditions we experienced following the financial crisis. But as we become more confident that the economy is recovering and as evidence accumulates that above-target inflation is the worry, rather than deflation, then it is time to act. In my view, the time is overdue, as I have been making the case for higher rates for nearly nine months now. And that is why I voted at the February meeting for an immediate rise in Bank Rate to one percent. As emphasised earlier, that would still be a very low rate of interest by historical and international standards. And in the absence of a significant change in economic conditions across the global economy, I would expect that this would need to be followed by further rate rises later this year – though the pace of increase would need to depend on the evidence both in relation to the progress of the recovery and the balance of medium-term inflationary pressures.

Ten becomes one

We have just passed the anniversary of the decimalisation of the currency here in the UK. I am afraid I am old enough that I remember it well. My elderly piano teacher never got used to the new decimal currency. She continually asserted that "the old money is coming back". It never did of course, and there are many advantages of the decimal system we adopted in 1971.

A great benefit of a decimal or metric system is that a unit of ten can become a single unit in the next column of arithmetic. For example, 10 millimetres becomes 1 centimetre, making the process of converting from one

unit to another much easier. I have given ten reasons, which I believe to be good reasons for tightening UK monetary policy now. But if I could summarise them as one short statement, it would run as follows.
We relaxed monetary policy in late 2008 and throughout 2009 to forestall a deepening recession and head off the risk of deflation. That policy was both right and successful. But since then, we have experienced recovery at home and abroad and significantly above target inflation. It is time to change tack and adapt our monetary policy settings to the changed economic climate. The time has come to increase interest rates. We should increase them gradually and slowly if we can. But the risk of delaying interest rate rises too long is that this gradual approach may cease to be an option in the future.

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