BANK OF ENGLAND

Speech

Why the Bank Rate should increase now

Speech given by

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Background

The last few months have seen continuing volatility in Britain's economic data. After a fall of 0.5% in the fourth quarter of last year, GDP has risen by the same amount in the first quarter of this year. So over the two quarters taken together there has been no economic growth – an outcome weaker than many people, including me, had expected two or three months ago, but nevertheless one which has not fulfilled fears of a new contraction. The inflation rate moved sharply higher in January, under the influence of the increase in VAT. And it has moved higher since, reaching 4.5 per cent in April, but possibly boosted by the date of Easter. As you know, I first voted for a rise in Bank Rate at the January meeting and today I would like to consider the continuing case for an early increase in Bank Rate.

The economy has suffered from an adverse demand shock – the sharp contraction of 2008-2009 – and from two types of adverse supply shock. First of all, the trend path for productivity is almost certainly lower than most people had expected before the economic crisis (although trend growth is probably little changed). Not only did productivity levels fall during the crisis, but there has been no real sign of the sort of recovery which might have been expected if the decline in productivity had simply been a temporary consequence of the disruption associated with the credit crunch. Secondly, commodity prices have risen sharply. We have also experienced an exchange rate depreciation which may not have worked its way fully through the system.

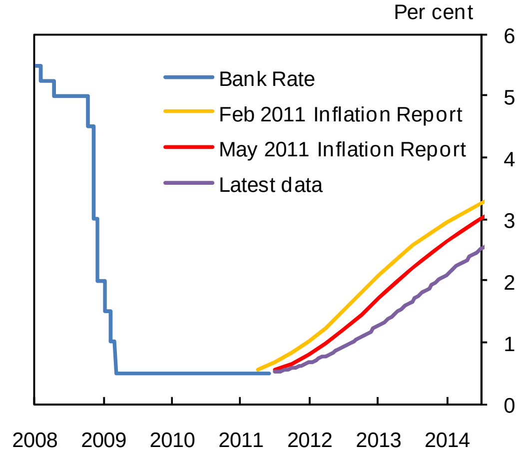
Things have improved since output reached its trough in the Summer of 2009. Nevertheless, in order to demonstrate just how severe the contraction has been, let me put it in a historical context. Excluding the distortions of the Second World War there have been six periods, beginning in 1920, 1930, 1973, 1979, 1990 and 2008, when the output of the economy has been depressed below a previous peak. The longest two of these five complete phases of what one might reasonably call economic depression were those which began in 1930 and 1979, each lasting for forty-eight months, while the most severe was that which began in 1920 but lasted for only forty-five months (Mitchell, Solomou and Weale, 2009). But, on the basis of ONS-consistent data for the period up to March of this year (which, of course, may be revised), and the forecast for GDP growth in the *Inflation Report,* output is now not expected to pass its level of March 2008 until late in 2012. If this proves correct, it will make the current period of below-peak output the longest such period sustained by the British economy since 1920 and, quite possibly, the longest of the industrial age. Had output continued to grow from the start of 2008 at its trend rate, then our GDP would be more than 10 per cent higher than it currently is; this output loss is largely the counterpart of the shortfall in productivity which I mentioned above.

Given this output loss, it is understandable that most members of the MPC are reluctant to raise interest rates. More importantly, no one is proposing that monetary policy should be set to anything except a very expansionary stance. But I would like to explain why I think it is appropriate for the Bank Rate to be increased from its current very low level.

Monetary Policy and Inflation

How should monetary policy be set when inflation is high and economic growth is weak? Slack monetary policy is needed to support the economy but surely something needs to be done to deal with inflation, at least unless there are good reasons to think that it will fade away of its own accord. At one level the question, whether action is needed, can be answered from the *Inflation Report*. The MPC presents two sets of forecasts, one based on the assumption that interest rates follow the pattern shown in the market and the other compiled with a constant interest rate. The market rate forecast extends for three years ahead while the constant rate forecast extends for only two years. The interest rate profile for the latest market rate forecast is shown in Chart 1 together with that used in the forecast for the February and May *Inflation Reports*. As the chart shows, interest rate expectations have fallen since the time of the May forecast. This is, in itself, of course a clear easing of the monetary stance because some lending terms are fixed with reference not to the current Bank Rate but to the interest rates shown in Chart 1. As I shall discuss later, the data appearing over the last three or four weeks have been relatively weak and the declining yield curve may reflect this. But I would like to start by focusing on the forecast and its implications.

Chart 1: Market Interest Rate Expectations[(a)]



(a) The February 2011, May 2011 and latest data are estimated using OIS rates in the fifteen working days to 9 February, 4 May and 10 June respectively.

The forecasts themselves are presented as fan charts replicated below.

Chart 2: Inflation Prospects with Bank Rate at 1/2 per cent

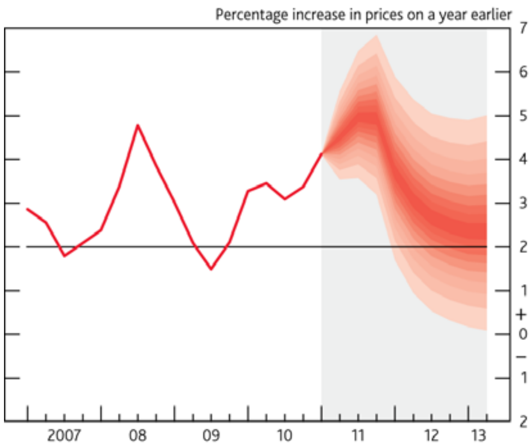
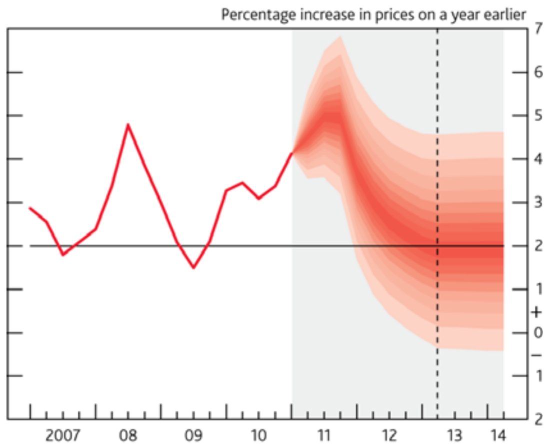


Chart 3: Inflation Prospects with Market Interest Rates



The charts give a fairly clear message. The collective judgement of the MPC in May was that, if the Bank Rate were to be held constant for the next two years, it would be appreciably more likely than not that inflation would remain above its target. Chart 2 might be taken to suggest that, if rates remain unchanged, inflation will settle not very far above target. Someone who puts that interpretation on it might then expect the MPC to consider the net benefit of being on target with some increase in rates rather than slightly above target with no increase in rates, perhaps coming down in favour of the latter. But the reality is that any policy of holding the interest rate constant is likely to be unstable. The MPC must be prepared eventually to address above-target inflation by higher nominal and real interest rates.

Furthermore, there are good reasons for thinking that the difference between the inflation profiles in the two charts might understate the full impact of a constant-rate relative to a market-rate path. My own view is that, if there were to be a firm expectation that the MPC would be likely to hold the interest rate constant over the next two years, then the exchange rate would fall further than is assumed in the constant rate forecast. In all probability this would mean that inflation would be higher than in the simulation from which Chart 2 is constructed.

Chart 3, showing the MPC's views on the inflation outlook with market interest rates, suggests that, if interest rates were to follow the May path set out by the yield curve (shown in Chart 1), then the most likely outcome would be that inflation would be just below target in 2013, after being above target until then; the assumptions that the MPC makes about the risks to its forecast mean that the expected outcome is not the same as the most likely outcome and this expected value is in fact slightly higher than the most likely outcome. But the overall picture is very similar to that described in the February *Inflation Report*, except that, as Chart 1 indicates, the May interest rate profile shifted about six months to the right as compared with February. The main point to be gleaned from these two charts is that the collective judgement of the MPC as shown in the May forecast was that, for inflation to be brought back to target interest rates must be expected to rise.

That interest rates must eventually rise should hardly be a surprise either to market participants, or indeed to the typical family with a mortgage. Only five years ago the standard variable mortgage rate was nearly 2 ½ percentage points higher than it is now. And if we read the runes of the term structure of interest rates, these suggest that, in ten years time the Bank Rate is expected to be over 5 per cent.

Of course it can reasonably be objected that forecasts are simply forecasts; they are at least as important for providing a structure for thinking about the economy as they are as a guide to forthcoming economic developments. And we are continually reminded that different forecasters produce very different forecasts. The National Institute is less optimistic about growth than is the *Inflation Report*. And it also takes the view that the inflation rate will fall off more rapidly than the *Inflation Report* has projected. But the key point is that the National Institute also assumes that the Bank Rate will rise in line with market expectations. It forecasts an inflation rate of 1.4 per cent in 2012 Q4 but which is expected to rise to 1.8 per cent in 2013 Q4. The National Institute does not tell us what inflation would be with Bank Rate held at ½ per cent for the next two to three years, but a reasonable assumption is that it would be above target in early 2014, if not a year earlier.

We should not make the mistake of thinking that, by somehow looking at two rather different forecasts, we are necessarily allowing for everything that could go awry. The dispersion of economic forecasts is not, and should not be expected to be, any sort of indicator of the uncertainty facing the economy. But it is nevertheless a fact that two very different forecasts lead to much the same conclusion. If the inflation target is to be met in three years then, on the basis of what we know now, it is most unlikely that the Bank Rate can be held at ½ per cent for the next two to three years. It seems very likely that rates will have to rise at some point.

An Alternative Interest Rate Profile?

At the same time, it can hardly be the case that the market profile is the only path for interest rates which might bring inflation broadly to its target over the next two to three years. Intuitively one might expect that an earlier rise in interest rates could also deliver the target in early 2014. Equally the first increase could be delayed. We cannot know what would actually be needed but we could, in principle, use economic models to explore alternative paths. There is, however, a substantial obstacle to doing this in any convincing way.

As the May *Inflation Report* (p.39) explained "modest differences in judgements... can have a material impact on the outlook". A path which seems desirable from one perspective may seem less desirable from another perspective. At present important judgements include issues of how persistent inflation is likely to be; if expectations of future inflation are based more on the recent past (as Phelps (1967) originally suggested) than on a belief that the MPC will deliver the inflation target, then inflation may be not be brought back to target to any particular timetable without a fairly aggressive monetary tightening. Similarly, if wage bargainers resist the sharp reductions in real wages which are implied by our forecast, by more than we anticipate, then wage pressures may be undesirably strong. On the other hand, we have taken a gloomy view about the extent to which there is spare capacity in the economy and, should there be more than we have assumed, then inflation may be weaker than we have projected. These problems of modest differences in judgement arise with any model-based analysis of optimal policy, such as that presented recently by Laséen and Svensson (2011).

So instead of discussing this topic further, I would like to review the argument for an early rise from the perspective of someone who is broadly comfortable with the inflation forecasts of the May *Inflation Report.* In that sense I am presenting here an analysis complementary to that of a number of my current and former colleagues (Dale, 2011, Fisher, 2011, Posen, 2011, Sentance, 2011). They have explained the range of factors which lead them to expect outcomes different, to a greater or lesser extent, from the central position shown in the *Inflation Report*. I myself am probably closer to Spencer Dale's position than to the others although I can see merit in the range of different views. But rather than reiterate these arguments, here I want to explain why, if one is completely comfortable with the central position of the *Inflation Report* or even if one is somewhat more optimistic with regard to inflation, it would be a good idea to raise the Bank Rate now.

First I will describe how the forecast presented in the *Inflation Report* leads me to that conclusion. After this I will explain why, although the data which have appeared over the last month or so point to a softer outlook for economic growth and probably a slightly more favourable prospect for inflation in the medium term, they do not change my overall conclusion.

The Case for an Early Rate Rise

The case for a rise can be put quite simply. An early increase in Bank Rate makes it more likely that the inflation target can be met in two to three years time because it allows for greater subsequent flexibility. If inflationary pressures subsequently prove more severe than the central part of our forecast suggests, then it will be a help to have started to raise interest rates earlier. But if they prove less strong then subsequent increases can be slower than would otherwise be the case. Indeed, if the economy is extremely weak, interest rates can be reduced again.

This point carries particular weight with me given the fact that we have exceeded the inflation target in thirty-four out of the last forty months. After such a record, the risks that expectations of above-target inflation will become entrenched into people's behaviour must be greater than they would be if our recent record were better. As a consequence being in a position where we can address worse than expected inflation, rather than simply see slippage in the date at which inflation is expected to return to target, is important. To put the point another way, while there is as yet no substantial evidence that expectations of above-target inflation are being built in to people's behaviour, there is a strong case for the MPC to pre-empt this risk rather than wait for it to materialise.

The need to pay attention to the possible damage from upside slippage is re-inforced by the observation that, as far as forecasting goes, the MPC is all too human. Groen, Kapetanios and Price (2009) carried out a careful assessment of the *Inflation Report* forecasts, for the period from Bank of England independence in 1997Q3 up to 2006Q2. They found that the *Inflation Report* forecast of inflation out-performed nearly all of the range of alternative, purely statistical, models that they examined at one quarter, four quarter and eight quarter horizons. Such a finding is comforting but does not, nevertheless, mean that the Bank is particularly good at forecasting inflation. Over the twenty-one quarters since the inflation target was calculated from the CPI at the beginning of 2004, its forecast of the inflation rate two years ahead out-performed the independent forecasters twelve times – only slightly more than half. So we need to think about what is a sensible policy given the risks that inflation will be different from forecast.

The argument for an early rise is based on the specific risks arising from recent inflation rates and the problems which could arise if there is further slippage. These make it desirable that the inflation target should be delivered over the horizon shown in the current forecast, rather than simply at a date which recedes into the future. An early rise makes this more practical without making it difficult to have a slacker than expected monetary policy over the next two to three years should that be needed instead.

This does not of course mean that an early tightening is completely costless. In the short term the performance of the economy will be weakened slightly. But, if the underlying inflationary pressures are correctly judged in our forecast, interest rates further in the future will be lower than is shown by the market profile and some stimulus to output is then likely. In any case the overall impact of a small change to the Bank Rate on output is likely to be very small.

Developments since the May Forecast

Since May we have seen a succession of relatively weak output indicators. As I noted earlier, the second release of the GDP figures for the first quarter of 2011 confirmed the picture of a stagnant economy. Less importantly, from my perspective, there has been a range of relatively weak qualitative business surveys. I say less importantly because these measures typically are not individually very informative except during periods of sharply falling output. Recent hard data, however, include the figures of industrial production in April. The decline that these showed was less than might have been expected given that there was an extra bank holiday. I also note that measures of consumer confidence, which are informative only insofar as they stand proxy for movements in household incomes, although still weak, have shown some improvement from the very low levels recorded in the Winter and early Spring.

Internationally, not enough attention may have been paid to developments in our near neighbours. Employment figures for Germany have been very strong. There unemployment has fallen to its lowest level, as a share of the labour force, since 1992 and employment is now at its highest since unification. On the other hand, as in the United States, there are indications that second quarter economic growth will be weaker than it was in the first quarter of this year.

News on costs and prices has been mixed. Oil prices fell in May and, like me, you may have noticed the price of petrol at the pumps declining slightly; however, there is the risk that the combination of continuing supply tightness combined with buoyant international demand will lead to renewed upward pressure. In any case families will have to face increased domestic gas and electricity prices, following the rise in oil prices earlier in the year. Other commodity prices have fallen slightly since the start of the year, despite being still nearly thirty-five per cent higher than a year ago. But the price falls a month ago, which looked as though they could turn into a collapse, have not continued and the short-term impression is of stable rather than falling prices for commodities.

At home of course, the April inflation rate, measured by the Consumer Price Index, is, as I mentioned at the start of this talk, 4.5 per cent. Even if one leaves out the effects of VAT and other recent tax increases, the CPI is still 3 per cent higher than a year ago. Moreover, despite the slightly more favourable news arising from factors such as the easing of oil prices, there is still a substantial risk that the headline inflation rate will rise above 5 per cent per annum later this year.

Turning to domestic costs, I have, of course, been pleasantly surprised that wage settlements in the private sector have remained low and that private sector regular weekly earnings are rising by less than 2 ½ per cent per annum. But a more general picture of unit domestic costs excluding taxes can be obtained by looking at the gross value added deflator. This rose by 1 per cent in the first quarter of the year and by 2.4 per cent compared with the first quarter of 2010. So it is consistent with the view that, even after excluding import costs and taxes, there are at present substantial cost pressures in the economy.

Overall these observations probably do mean that in the short term economic growth may be slightly weaker than we had hoped. But monetary policy cannot be used to fine-tune output effectively in the very short-term any more than it can sensibly be used to bring inflation back to target in the very short term. The real question that these observations raise is whether they imply that inflation two to three years in the future is likely to be so much weaker than the May forecast suggested that the need for a substantial rise in rates over a two to three year period disappears. My own view, in keeping with that of the current market yield curve, is that so far they do not. This means that the case for an immediate quarter point increase, and the extra flexibility that it gives, remains.

The Relationship between Monetary and Financial Policy

You also asked me to say something on macro-prudential policy. I do not have much time and would like to limit my observations to the way in which it interacts with monetary policy. Both capital and liquidity requirements on banks influence the margins between deposit rates and borrowing rates and thus both incentives to save and the terms on which credit is available to the economy. From the perspective of monetary policy, however, the point is that the Monetary Policy Committee would take the plans of the Financial Policy Committee as a given when setting monetary policy. This is very similar to the way in which we treat fiscal policy. If the FPC were to impose requirements likely to have the effect of limiting bank lending, that could be a reason for setting a monetary stance looser than would otherwise be the case. Were they to make changes expected to stimulate bank lending then the opposite would probably be true. And the overlap in membership means that we should avoid the problems which could arise from conflicting goals. But, more importantly, this is only a part of the general environment – for example the gap between bank lending rates and the Bank Rate is already much higher than it was before the crisis and our setting of Bank Rate takes that into account. If banks were, at present, lending at only small margins above Bank Rate we would need the latter to be higher than it actually is.

Conclusions

I began by observing that the May *Inflation Report* forecast sets out clearly that there is a need for monetary policy to tighten. Arguments can be produced for delaying the start of that tightening process. But there are significant risks to delay. The belief that delay is – as the market yield curve shows – possible does not mean that it is a good thing. But equally it needs to be understood that an early rise in rates does not itself imply that, averaged over the next three years, monetary policy is on average, going to be tighter than the market curve, even after its recent fall, suggests. What it will do is reduce the speculation that the Bank has departed from its inflation mandate. This itself will reduce the subsequent risks and may, indeed, mean that, averaged over the next three years, monetary policy does not need to be as tight as the current yield curve suggests. I should finish by pointing out that I think these arguments remain valid even if inflation is expected to be appreciably weaker than was forecast in May. Even with weaker expected inflation it remains likely that more than a trivial increase in Bank Rate will be needed over the next two years and that beginning the process will make it much easier for the Bank to preserve its credibility should inflation turn out to be higher than expected.

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