

**Monetary Policy, Stability and Structural Change**

# Speech given by

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1

Monetary policy, stability and structural change

Judging by the macroeconomic data, either there have we have been blessed by extraordinary good luck over interruption for1 50 quarters. Un1employment has fallen

*ICpneortmvhamisitvstpeeeece,hcdahi,s*(1*c*)*uPshsaaeussl osTtcurcucukcretrure,r*(2*a*)*liEscxheevacinudgteeinvsteaiDnff,iercfeotcirtnoegrxtafhomerpUMleKa, rleokcewotesnroavmnadyriaabnmidlietcmyobninefroounfttpitnhuget pgMrooliwncteyhtmaaarnykedPrso.licTyhat*

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*actions,*

Chart 1

been some fairly profound changes in our economy or

the past decade or so. GDP has grown without

from around 10 /2% in 1992 to 6 /2% in 1997, and just1 2

over 4 / % on the latest reading. Inflation fell through

th first half of the 1990s, and si ce 1997 has, on

average, been close to the Government’s target. All that

is, of course, well known.

But it may be less familiar that quarter-to-quart

changes in output growth and inflation have over recent

yoef aprrseevxiohuibsidteedcaadsetsr.ikBinogthly oduiftfpeuretngtropwattheranndfroinmflathtioosne

Absolute changes in quarterly inflation

Sources: Bank of England and ONS.

1960 65 70 75 80 85 90 95 2000

Percentage points

RPI

Consumption deflator

6.0

5.0

4.0

3.0

2.0

1.0

0.0

have been less variable (Chart 1; Table A). Inflation also toabte, wphroetrreaacsteind,thmeorpeasrtecriesnets folurcftaullastionisnfilnatiinofnlateionnded

hEanvgelabnedenansdhoortth-leirveedc.onWoomrkistusn,(d3)esrutamkmenarbiyseBdainnk of

1960*19*–*76*7*30*9*–792*

198930–292004

*1*1*0*1*.*.*5*1*83*0*8*

0..719

*0*0*1*.*.*7*517*6*1*

1*1*.*.*64*918*5*3*

(32) GMDBaiyvnmetkhn’esanawntkeLtsbyhsteioctCePBoeafntefweredwAoewnmr.dabtraienownnksto,ofIefanBngrBliatoinsndhd.caI, norSc.dpuhueksn/tpcreuyrbinlDoicaGalaetui,iolNdnefsao/atrsldpaHeoaentcch1hte,MsrJ/oa2fhor0cnr0h5Ww2/ch0srpi0tel5ea.ychTa2hn4ids0Ts.popdnefeyr.cYhaitceasnfobrecfopmunmdevonntsp;thtbeolished in

TaapbplaereBn, tsucghgaensgtes othcactu—rredatalreoausnt dsttahtiesttiicmaellyo—f thtehis

Source: Bank calculations.

0.3549

0.349

tfrhaisa*B*ii*u*n*lle*T*t*a*in*bn.lehPreoavriocufyrsowmoerBkenhsaasni,adLlsro(e2sd0eo0c5u)m, ‘aeTnnhdteedtintfShlaitsniodcnhr-anBagrgenen—tins gseeferafmoresexoaremktpfrloeia,mlBsautnpinphioi,sNtto.raVncodal.lN4p,elNrssoon.e,3cEt, ip(ea2’g,0e0su13),81‘T–h4e0l0ag.

om monetary polic actions to inflation: Friedman revisited’, *International Finance*, Winter,

seems to have become less persistent. By that, I mean

Table A Average absolute changes in quarterly inflation and GDP growth

Percentage points RPI Consumption deflator GDP growth

Table B

RPI inflation persistence(a)

4727 972 .5916

1992–2004 -0.05

Source: Banenhaitsit,oLri(c2a0l 0p5er),sp‘Tehcetivine’f,lpatuibonlis-thaerdgeitnintghifsra*B*m*ul*e*le*w*ti*o*n*r.k from

(a) Tatouhtieonrsfeltagttriieosstnsiciivssespheeqoruwmaatthnioennstuf.omrSieoneffltTahatebiolceno.CefAfoicvnaieplunaetgseoof1f16t6hineodflaitcghagitses*Bu*tthe*ll*r*e*am*t*t*in*as. isnhoacnk

United Kingdom’s introduction of inflation targeting in

1992.

The policy debate — inside and outside the Bank — has changes in the way our economy functions. Less than essentially because the MPC wanted to stimulate private aggregate demand of weak net trade, given adverse

recently refocused on the possibility of some other

18 months ago, th Bank’s interest ra e was just 3.5%,

sector domestic spending to offset the effects on

developments in the world economy. As global

conditions recovered, and with a pickup in public sector

spending, we we e able gradually to withdraw much of

that stimulus during 2004 in a series of steps which were

Chart 2

Bank of England repo rate and two-week forward curves

(a)

Outturns

No*In*v*f*e*la*m*ti*b*o*e*n*r*R*2*e*0*p*0*or*3*t*

Per cent 6.5

6.0

5.5

Fe*I*b*n*r*fl*u*a*a*ti*r*o*y*n*2*R*0*e*0*p*5*ort* 4.5

5.0

(a) BtiNnwaoonv-kewdmoeiefbkeErnfto2grl0wa0nae3rdductwcueuorvr-evweeiseukdperretipovoe5rdaraNftroeovmoeumitnbtuteterrrn2ss0ta0rna3dtea1sn5od-dn9agyFitleatbv-eerdrutagagereydFs2soe0fc0u5arr.iyti2s0, 05

4.0

3.5

3.0

Chart 3

crautcrelvu.e Bisontdgherhciuoversvdefsrsoarmde aiansdsjctuorsultlmeadteentotslaitlnhloaswthsofeortrt-ltdeirfofmenrretehnpecoeLscoownnidtohrantchinse.teBrabenbaknr’sukoofffiecriaeld

Earnings growth and unemployment

2000 01 02 03 04 05 06 0.0

interest rate.





wi ly anticipated and understood across the financial

ethceondoemgryeebeoifndgeambasonrdbpedre, sastuterenstiaonndsthhifetierdimtopgliacuatgiionngs some simple statistical relationships, a question has been extent to which demand pressures feed through into

and real economy (Chart 2). With the slack in the

w ges and prices. Most notably, as discussed in the

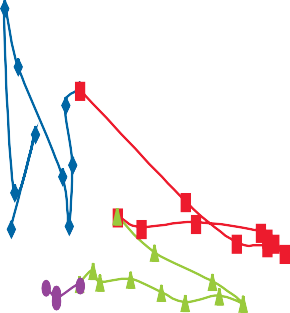
posed about whether there has been some change in the

f the inflation outlook. In particular, on the basi of

Bank’s February *Inflation Report*, the steady falls in

unemployment over recent years have not been

198710–89

1971

12909000––9094

1980

1990

2000

Average earnings(a) growth in Q4 30

25

20

15

10

5

a3c).coTmhpeaseniiesdsubeys aobrtisaiinedrastoemoef eparronminingesngcreowtotwha(rCdhsatrhte

0 L2FS unempl4oyment ra6te in Q1 (8per cent 1o0f workfor1c2e)

14 0

ednemd aonf dla, sitnyfleaatriownhoenn,thdesCpiPtIemapepasaurerentfleyllbtuoo1ya.1n%t .

1. OWchtobeeercaonndomNyo,veinmclbuedri.ng bonuses. 2004 data proxied by average of

Lower variability in output growth and inflation, lower demand pressures — all told, this points to the

inflation persist ce, apparently weaker pass-through of

importance of identifying and derstanding the

ceocomnpolexy.coTmodbainy,aItipolnanoftostgruivcetuarablrocahdanogvesrvaifefwecotifnsgomouer

of them, as they confront policymakers.

Ostautrissttiacnadl amrdodteololilns gof—ecaorneonmoitceasnpaelcyisailsly—weinll-psuaritteicdutloar, forces of change. They can, though, alert us to puzzles

when the d ta persistently deviate from past pa terns.

real-time detection or quantification of the underlying

Business managers, by contrast, are exposed to the reality

change, business s can indeed ucceed by embracing it That underlines he value of the Bank’s dialogu with across the United Kingdom. Colloquially, you enrich our tphueznzlehsewlpes suesetionmthaetcdhaytao.ur various real-world stories to

Inflation and firms’ price-setting behaviour

In the medium-to-long run, the average rate inflation pheorizoitntesd, dbeycitshieonmsotnakeetanrybyaubtuhsoinrietsys. eBs u—t oivnerpashrtoicrtuelrar,

is determined by the rate of nominal expansion

— shaping your environment as well as responding to it.

business, facilitated and led by our regional Agents

grasp of what is ‘going on out there’. Economic analysis

fdleumctaunadtiopnressisnuriensflfaeteiodnthanrodu, gmhotroe ignefnlaetriaolnly., how Economic policymakers draw on a number of ways of There is no model that can, uniquely, capture the

thinking about those influences on infl tion dynamics.

richness of the real world. But surprising though it may

be to some, one of the ways in which we think about

firms’ price-setting behaviour would be familiar to

anyone running a business. Namely, that firms charge a their various inputs — labour, capital, raw and

mark up, r profit margin, ver the marginal costs of

intermediate materials, etc — with both the mark up

and costs varying according to current and prospective indeed crudely, in Diagram 1. The key feature is that

demand conditions. This is represented schematically,

when demand rises and firms utilise their capacity more

fully and add to their labour force, their costs and

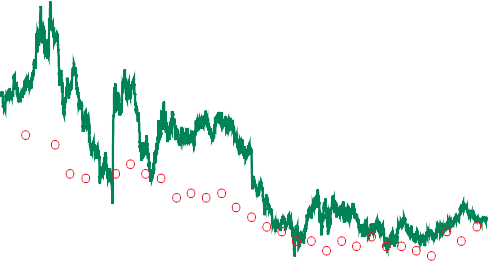
prices tend to rise. That might involve old-fashioned

‘cost-push’ inflation, with firms raising prices to maintain

simompoerptaenritofdosr aplotelircfyimrmaks’ecrso,sats atondfomrmaragivnise.wTohnathise distinguish between short-lived and persistent

Tinhfelumenocnee.tary framework is one such structural O e of the most couraging features of the post-1997 taanrcgheot rfeadirltyowthelel,teaxrpgetct(aCthioanrst 4of).inUflnactieorntahinatvye abbeoeuntwell

different in the past. A characteristic shared by the



future inflation has also fallen(1) (Chart 5). It was

Chart 4

RPI inflation expectations

Index-linked gilts

Consensus

Per cent 8

6

4

2

S1989 s: Conse92 s and B n95 alculation 98

(ao)urcIneferred expnescutations arekfcor five-yearsR. PI inflation in five years’ time.

2001

04 0

influences.Monetary regime change

medium-term outlook f r inflatio we need to

landscape has been that, as well as inflation tracking the

mfiramrgsinmsiginhtthineitfiaaclelyobfeinacbrle tseemdp(omrargiliynatol) rcaoissetsm. aOrrgins,

(a)

with labour and other costs later ‘catch g up’. In either wfuhtuatret.heAygtahininskimispgliofyininggt,otwhoapfepaetnurteosinarfleataidodneidnttohtehe wholesale — prices to the retail prices which the Bank

case, firms and wage bargainers will be influenced by

targets. First, as well as being an input to producing

diagram to bridge from firms’ so-call ‘output’ — or

firms, some imports are directly consumed by

households. Second, distributors — incl ding, most

obviously, retailers — add another mark up, reflecting the economy affecting any of the links in this (stylised)

factors from the more structural influences that over

challnenwgilel ihsatvoe saepbaeraartiengouotnciyncflliactaiol,nordytenmampoicrsa.ryT, he

Diagram 1

Inflation process

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(Idmirpeocrttlsy

Lcaobsotusr

Ocothstesr

Opuritcpeust

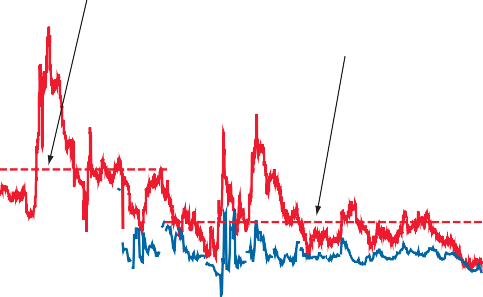
Disstericbtuotrion

r own costs and desired profit margins. Changes in

Chart 5

Implied volatility of a three-month option on a ten-year swap contract and ten-year option on a twenty-year swap contract

250



Average prior to establishment of MPC

Basis points

Average since establishment of MPC

Three-month/ten-year

200

150

100

Sources: Barclays Capital and JPMorgan Chase.

consumed)

Ten-year/twenty-year

(1) pTuagckeesr8, 4P–M96W. (2004), ‘Risk, uncertainty and monetary policy regimes’, *Bank of England Quarterly Bulletin*, Spring,

infClaPtiIon

1993

95

97

99

2001

03

50

0

various monetary regimes tried out by UK governm ts judge what rate of inflation the authoriti s were ying outlook for inflation. As feared by one distinguished vmeonntuetraer[yripsokslicbye’.i(n1)g]Intrtahnosfsoercmirecduimnstotaancsepse,ciut lmataiyonweolnl outturns were a good basis for guessing the near-term

have seemed reas able to assum that rece inflation

during the 1970s and 1980s was that no one could easily

to achieve — or, therefore, have much idea about the

economist of an earlier generation, ‘every business

phaotuhseohfoinldfslactioounl.d Aalnsdo ghiavveenbteheenefvoidrgeinvceen, ffoirrmasctaing on

Chart 6

UK labour share

Percentage of GDP 80

75

70

65

arenspaossnudmtpotieoxncetshsadtetmheanadutahnodristioestowuopuwldarbdepsrloeswsutores on

inflation.

S1o9u5r5ce: ON6S1.

67 73 79 85 91 97 2003 60

By contrast, the current regime se s, so far at least, to pdreilciveesr, ifnirgmins fmlaitgiohnt winelllinpelawceitmh othree wtaeriggehtttohnanponicryecent explanation for the much lower persistence in inflation I economy cause inflation to deviate from target, firms

enjoy high credibility. In consequence, when setting

may nevertheless set prices on the basis that it will

described earlier. In other words, when shocks to the

inflation utturns. If so, that might be part of the

return to target fairly quickly — which would, of course, vein, firms and households might now expect the

Bank to tweak policy fairly promp ly in response to

itself help to bring inflation back to target. In a similar

shifts in demand. In which case, the influence of such inflation, would plausibly be somewhat weaker than in

the past.

demand sh ks on wage and pric -set ng, and so on

But sound monetary policy is not the only important ainpfpluaerennctesfronmfiervmens’ acobsrtisefanexdapmriincaetsi.onI sohfarlel adli-seccuosnsojmusyt Lcoambpoeutritimveacroknedtitions in product markets.

gtheenreerfaolr—e beaennd pthroefoecuonndolymayffienctaegdgrbeygathtee— have

transformation in the United Kingdom’s labour market

euj fnfdecmtipvleolyymwehanatthtahtvetinMgPogCrahdausaallsysoufamlledn.itniTmhaatkiisnegcan

(21) SCSeihmei,cofanogsro, e.Hxa(m19p4l7e,),N‘Ricukleelsl,vSerasnuds aQuutihnotrinitii,eGs i(n2m00o2n)e,t‘aTrhyeproelciceyn’,tipne*A*rf*p*o*o*rm*sit*a*iv*n*e*c*p*e*r*o*og*f *r*t*a*h*m*e *f*U*or*K*la*la*is*b*s*o*ez*u*-*r*fa*m*ir*a*e*r*a*k*n*e*d*t’,*oOthxefroredssRaeysv*,*iew of*

rueasgoenmaebnlytscobnofiudenhteabuotulot othkef dririencftlaionono.f cWhange, but

*Economic Policy*, Vol. 6(4), pages 26–35.

change in the economic environment. That much is

three: the labour market, financing markets, and

Fmoarjomropsatrbtuosfintheessiresi,ntphuetircowsotrsk(fCorhcaertac6c)o. uFnirtms fsoirnthe

over the past quarter century. The key influences have not about its size.

been well documented.(2) In particular, industrial operate, and union membership has fallen (Chart 7). pUrsoegoref spsaivret-ltyimreefowromrekde,rsinhcarseainsicnrgeaisnecden(Ctihveasrtto8)w, oinrkp. art also more flexible ideas about working patterns. The each other — job search — have improved, helped by recently by the internet.

In combination, these developments provided the decade without adding to infl t nary pressure. During accordingly increased by more than would otherwise aggregat demand woul have put less pressure than ehfofewcetveorn, tfhiramt st’hceofsetesda-nthdrporuigcheso. fTdheamt adnodespnreostsumresnin, to apparently flat relationship, illustrated in Chart 3,

inv stment in employment exchanges and perhaps

conditions for unemployment to fall over the past

mechanisms via which employers and employees find

the transition, the supply capacity of the economy

have been achieved; and any given increase in real

otherwise on supply, and so would have had a weaker

relations legislation altered the way in which unions

Unemployment and social security benefits have been

due to the expansion of the services sector, a d perhaps

between unemployment and wage inflation is, at least in

inflation wil be permanently weaker. Instead, e

part, most probably a symptom of the sustainable level of

Chart 7

Percentage of workforce with trade union membership

Chart 9

Real household disposable income growth and terms of trade

Per cent 60

8 Percentage change on a year earlier

1990 = 100 112

6

50 4

+

Real household income growth

108

2

40 0–

104

100

30

4

20

2 Terms of trade

6 96

92

1970 74 78 82 86 90 94 98 2002 0

Sources: LpoFfaSgtheasen2Ud6KN–3ilca5b.eolul,rSmaanrdkeQt’,u*O*in*x*t*f*i*o*n*r*i*d*, G*Rev*(2*ie*0*w*0*o*2*f*),*E*‘*c*T*o*h*n*e*om*re*ic*ce*P*n*ol*t*ic*p*y*e, rVfolr.m6a(n4c),e

Chart 8

Proportion of part-time workers

Percentage of total employed 30

25

20

15

8 1990 92 94 96 98 2000 02 04

has increased in various sectors — partly associated

with the enlargement of the EU’s single labour market.

If that continued, with new residents continuing to help athvaeileacbolneotmo yUcKobuuldsipnoetsesnestiwalolyuladccinocmrmeaosde,aitme pstlryoinnggetrhat available data do not really enable us to get beyond

anecdote and speculation.

gregate demand than oth wise. However, the

to meet particular skill shortages, the labour supply

# Financing

Awnoorktihnegr cimappiotarltaanntdininpvuetstfmorefnitr.mHs iesrefintoaon,cteh—erefsoerem to

So19u8rc5es: ON8S8and Ban9k1calculati9o4ns. 97 2000 03

05 10

have been cha s — in the range and terms of the

hexotuesnethoofldcysc—licathl faltuctuualdtiopnostein oiaulltypuintfalunednicnefltahteion.

sources of finance available to both firms and

households depended on bank loans for external

That can be illustrated by the current conjuncture. Over

the past few years, there have been at least two other

imfplureonvecmeseantt winoroku. rF‘tiersrtm, fsoorfstormadeey’. eTarhsawt emeanjoty, esdimapnly we produce and export rose relative to the aggregate

ic s our imports. This increased the purchasing

put, that the aggregate price of the g ds and services

power of households’ incomes (Chart 9), and so may

have dampened wage pressures a the labour market

tightened. To the extent that this explanation should be pointing to an upside risk to earnings growth looking

ahead.

given any weight, it would end to be a temporary factor,

A second apparent feature of our environment works the

other way round. Anecdotally, the role of migrant labour the new monetary regime may make a difference.

One c aracterisation of the past would b that firms and finance; and that banks loosen d or tightened credit cycle, reining back whe the economy suffered a UfinnaitnecdeKdiunrgidnogmth, etheiasrilsy w19el9l0dso’ cruemceesnsitoend.(f1o)r small-firm

Although the stability of output growth over the recent reasons to think that cyclical swings in the av lability of past. In the first place, the greater stability brought by

past happily deprives us of a proper test, there are

finance may now be somewhat less marked than in the

conditions sharply in the different phases of a business

downturn and arrears and losses mounted. For the

(1) B‘TahnekfoinfaEnncginlagnedn(v2ir0o0n4m).ent for smaller firms over the last decade’, in *Finance for Small Firms — An Eleventh Report*,

Cmoomneptaarreydawuitthhorthitey pdaeslat,yitnhgerae rsehsopuolndsebetoleisnscripisikenotf the

Chart 11

Composition of UK PNFC sector gross debt

inflation until the point that it is forced to slam on the

iansfhlaatriopnspeixkpeecintautinoenms palnodyminentht,eloparoncdeessfacuoltnstrainbdutbinangkto

losses.

brakes, effectively engineering recession to quell

A more stable macr conomic e vironment may al o, by npeurmhbaeprs osof minefluciernccuemssftoasntteirailnegvcidoemnpce oitfiothna. tTihne, rfoeris

example, the decline in margins on personal loans

reducing the risks for new entrants, be one amongst a

(Chart 10). That would tend to reduce the credit

(a)

cabvoanislatrbaiilnittys ofaf cloinagn hporoudseuhcotsldtsh.atAsendaobelsethoeminecorwenaseersd to

Chart 10

Margins on personal loans to households

orrow against the free equity in their houses.

Source: Bank calculations.

Per cent 10

8

6

4

2

0

(a) Spread of effective personal loan rates over Bank of England repo rate.

OSetchuerritdiesbtother than shares

Borrowing from nUoKn-r-eUsKidreenstidMeFnItsMFIs

100

Per cent

80

60

40

20

1990 92 94 96 98 2000 02 04 0

Broadly similar changes have been unde way in business baanrkentsg. sTechteorprtohprortgihonfiromf Us’Kacncoenss-ftionarnicchiaelrfcirampist’al

1993 95 97 99 2001 03

debt accounted for by bonds has risen from around

finance, where competition also comes from outside the

cernehdaint craettihoneierdaibnilaitny etococnoopme iwcidthowcynctluicrnal; eacnodnommaiyc shocks, output growth and inflation may vary a little less respond less aggressively than in the past to keep the

But, again, it can be difficult to disentangle cyclical from premium priced into financial instruments. To pick

economy on a stable path.

than otherwise, and monetary policy may need to

fluctuations. If that lped to dampen the effect of

more durable changes. A topical example is the risk

just one indicator, corporate credit spreads have been

fmalildin-1g9f9o0rsa(Cfehwarytea1r2s),.toInledveglsrethe,athlasttspeeremvsailliekdeliyntothe environment together with balance-sheet strengthening industrialised countries. But, conceivably, it also reflects

better diversification of risk — facilitated, for example,

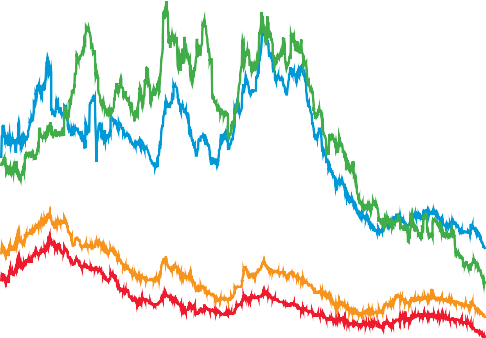
the corporate sector of a number of major

reflect a relatively b ign glob macroeconomic

Chart 12

Corporate credit spreads

1,000 Basis points H(ilgehft-yhiaenldd scale)Basis points 300



1fi5rm%sinha1v9e9a0cctoesosvteor t3h0e%innteorwna(Ctihoanratl 1c1o)m. mOeurrclialgpeaspter, markets for managing their financial risks. For smaller to have been an expansion in asset-based financing effectively.

and households somewhat less exposed to being severely

Taken together, a richer supply menu may leave firms

(1) Hewitt, A (2003), ‘Asset finance’, *Bank of England Quarterly Bulletin*, Summer, pages 207–16.

0

Sour

ce: Merrill Lynch option-adjust corporat

2000

01 ed 02 e bond 03

spreads.

04 05 0

options en(a1b) ling them to utilise collateral more

firms, compared with a decade or so ago, there seems

bond and asset-backed ma kets; and to derivative

800

600

400

200

BBB (right-hand scale)

AA (right-hand scale)

AAA (right-hand scale)

250

200

150

100

50

by the rapid growth of new instruments such as credit

derivatives and by greate cross-border investment of

savings. If so — if risk premia were systemically lowered

— that would tend to reduce firms’ cost of capital and

inrcicr(ee1a)osferhisokumseahyojludst’ fbineanemciaplowraerailythl.owA,ltpeorsnsaibtilvyeltyo,othe about the durability and macroeco mic implications of

the changes seen in the financial environment.Mark ups

low. The upshot is that we cannot yet be confident

Chart 13

Share of world imports in world GDP

1995 = 1 1.5

1.2

0.9

0.6

0.3

It is a commonplace that competition has intensified. Tfahmisiliara. ssWoocrialdtetdrawdiethha‘gslogbroawlisnatrieolant’.ivTehteo fwaoctrsldaroeutput notably in Asia, have become material participants in the of their production, or outsourced to firms operating in these developments, although also increased investment and in consumption has steadily risen

(Chart 14).

specialisation, the share of imports in UK business

markets with cheaper labour costs. Partly reflecting

world economy. Some UK busin sses have reloc ed part

(Chart 13). A wide range of e rging market economies,

Tdoheseefdfevcetilvoepmcoemntpsemtitaikoenmpoarlikceyt.s Amnoerexacmonpltesitnabrelec.enAts those prevailing on continental Europe.

years was the car marke , where prices converged with

Sources: I(MprFe-*W*19*E*8*O*0)S. ummer 2004 database (post-1980) and United Nations0.0

Chart 14

Import shares in consumption and business investment expenditures

45

1970 74 78 82 86 90 94 98 2002

Per cent

Business investment(a)

Consumption(b)

40

35

30

25

20

15

10

5

1970 75 80 85 90 95 2000

Tcohnetienstearbnileity, ,obryem-caokminmgeirtcae,laoltsoeabsrieinr gfos rgrbeuastienresses to

Source: ONS. 0

1. Iomf pfooordte, dbecvoenrasugmesp, ttioobnaciscomaenasducreadrs.as aggregate expenditure on imports

a) Rati of imported capital goods to business investment, chained volume .

Table C

conecsukmtheersptroicceosmopf acroemppreictiensgascuropspslideirfsf,earenndtfroertailers

Value of sales over the internet by UK non-financial sectors

£ billions Households Business-to-business Total

Ofirvmers’tmimaer,gtinhses—e foartcleesaswtoiunldsebcetoerxsptehcattewdetroerneodtuce

business managers have commented that, when inflation

20032 161.4 2182.2 319.50

eviously especially competitive. So long as that tgeivnedntosebt eoflodweemratnhdancownoduiltdioontsh. eIrnwiasdedbiteioimn,pilfieadndby any more aggressive in controlling costs in the face of

(Table C).

fluctuating demand, which might weaken the

when their marg s became thinner, firms might become

process of adjustment was underway, inflation would

pass-through of demand shocks into inflation.

those effects. Over recent years, more than a handful of potentially make to broader economic welfare.

Source: ONS.

wimaps lbeomtehnhti—gh oanr d‘gehtigahwlyayvawriitahb’ l—e, itpruisceedintocrbeeaseeass. ieIrntao business customers and consumers to distinguish

relativ price changes from increases in the general

low inflation environment, it should be easier for

price level. That too should foster greater flexibility and

(1) See, for example, Section 2 of ‘Financial stability conjuncture and outlook’, *Financial Stability Review*, December 2004.

The new monetary framework might reinforce some of

ecoffnictireibnucytioinnsouthraetcloonwoamnyd; satnadblies ionnfleatoiof nthcean

One striking example is the distribution sector. intense. This seems to manifest itself in the aggregate

Anecdotally, competition in UK retailing has been

data in two phases. As d(1o)cumented recently by my MPC

lleague Steve Nickell, retailers’ margins were Sthinrocuegth emne, athsueryes deemlivteorhinagveracpriudshperdodtuhcetiirvcitoysgtsrowth.

compressed in the years around the turn of the century.

In part, that ppears to h ve been achieved by

disintermediating wholesale distributors, whose margins effect was, for a period, to open up a gap between

producer output price inflation and retail goods price

have continued to fall (Chart 15). At a macro level, the

inflation (Chart 16). In other words, for a while some feed-through of demand pressures into retail price

inflation. Looking ahead, one downside risk to the

struc al changes in the distribution sec or reduced the

MPC’s central projection is that we cannot rule out that

this process has further to go.

Chart 15

Distribution sector profits (margins)

# The current conjuncture and policy

Monetary regime change, labour market reform, globalisation — it is a heady combination, which

financial innovation, the technological revolution,

unavoidably adds to the challenge of discriminating

between cyclical and structural influences when forming unavoidable that policymakers must try to do just that. Tpohlaitcyb. rings me to the current conjuncture and so to

a view on the macr e nomic outlook. But it is equally

My own take present is as follows. In my judgement,

there is, on balance, most likely a degree of excess

demand in the economy. Surveys suggest above-average ecvoisdtse,nacnedininthaenercisdeoitne of tspoumtepfriircmesinbfelaintigonabrleelatotivpeastos

on cost increases (Chart 17).Chart 17

capacity utilisation. And there is some corroborative

Domestically produced manufactured goods: costs and prices

Percentage of output at basic prices 25

Total distribution sector Retail

Wholesale

Poenrcaeynetaargeacrhliaenrge

Percoennataygeeacrheaanrlgiers

15 8

20 10 Ou(rtipguhtt-phraincedsscale) U(nrigt hwt-ahgeancdosstcsale)

6

15 5 4

10 0+ 0

–

+–

2

5 5 2

4

10

1992 94 96 98 2000 02 0

Chart 16

Output price inflation and CPI goods price inflation

Percentage changes on a year earlier 4

Input prices (left-hand scale) 6

1996 97 98 99 2000 01 02 03 04 8

15

Geairvneinngastiignhfltatlaiobnouhravminargkbete,ehnorweldaotievseltyhsaut bfidtuweidth? One firms have in the first place increased output by making

possibility that as aggregate d mand has picked up,

Producer output prices 3

gwroeualtderbuesceoonfstishtenrtewxiistthinagnewcodroktfoalrceeviadnedncceapoiftafilr.mTshat

2

0

+–1

having held on to labour during the earlier slowdown in

pLoroodkuincgtivaihtyeagdr,oiwt twhoouvledratlhsoe psuagstgeysetara odregsore(eCohfart 18).

aggregate demand; and with the pickup in private sector

CPI goods 1

2

1997 98 99 2000 01 02 03 04 05 3

upwards pressure on earnings growth.

AcosnrdefilteiocntesdoifnetxhcesFsedbermuaarnyd2, 0co0m5 b*In*in*fl*e*a*d*tio*w*n*it*R*h*ep*th*or*e*t*,

(1) Nickell, S (2005), ‘Why has inflation been so low since 1999?’, *Bank of England Quarterly Bulletin*, Spring, pages 92–107.

Chart 18

Private sector productivity

Percentage changes on a year earlier 5



Chart 19

Private sector factor utilisation (based on production functions)

(a)

Elasticity of substitution = 01.5

Percentage deviationfromoturtepnudt 8

6

+2

4

–0

2

4

S(ao)urcBebeat:siemBdeaonnk oaonf Eahnsesgu—lamneddcparlcoudluactitoionns.tfuensctitmioantewdhtiochbededsuceribpeusretlhyetoreclahtaionngeshs iipn

1986

90

94

98

2002

6

8

thseetwutaeitlneissiantipfoutntsofcthhaleanbignoepusurintasn.odutcpaupital — an output. The measures show

Per head Per hour 4

3

2

Per job 1

1995 97 99 2001 03 0

Sources: Bank of England and ONS.

lgirkaedliuhaololydroisfinstgrobnagcekrtoimwparodrst panridcetsh,rpoouignht tohein2f%lattiaornget around that central outlook but, taken together,

compared with November 2004 I judge them to be

over the next two years or so. There are many risks

slightly less to the downside over the medium term. The

—thenienefldattioonketeaprgseotm.

eInpNerosvpeemctbiever 2ab0o0u4t, dtheeviyaetiaor-nosnf-ryoemar

recent rise in CPI infl ion suggests, for example, that we And, as I discussed earlier, the puzzle about the apparent somewh by the Committee’s judgement that the yfeeeadrst.hTrohuagt hletaoveins fclaotniotinn,ulionogkidnegmaahnedadp.reWssiuthresmloikneeltyatroy concluded at the MPC’s latest meeting that our interest

rate sh ld be increased by 25 basis points — a small

p li y n ding to be set on a medium-term view, overall I

were not stuck materially below the inflation target.

weak feed-through from demand to inflation is reduced

performance of the labour market improved over recent

tweak to reflect the outlook. Bcount,siadsemraybrlemuanrckesrtaoidnatyiehs.avTeweomfpinhaalstisheodu,gthtesreabaoreut

them.

The first concerns the precision with which any old days, it should probably have been clear when the In today’s world, when we discuss excess or deficient deviations from trend than in the past, s Chart 19 condition lie w l within the margin of error of n gthiveeencuonoemryta. inIntyaasbiomuiltatrhveesintr,uwcetu—ralacnhdancogmesmaeffnetcattionrgs

monetary authority can achieve its objective. In the bad

economy was experiencing unsustainable excess demand.

demand we are generally addressing much smaller

suggests. In consequence, our debates about cyclical

sensible estimate of underlying trends — especially

mwaesas1u.6re%o. f CPI inflation was 1.1%. By January 2005 it Second, when inflationary problems loomed in the past, households and in financial markets — increased, both inflation exTpoedcatya, twioenasp, pwehairchtoweilnljaofyfewcetlpl-raincceh-soertetidng

modern economic models of various kinds — inside and anchoring medium-term expectations. If that were so,

inflation expectations — amongst businesses,

signalling and bringing about the incipient rise in

the medium-term outl ok for inflation would be assured.

outside the Bank — tend to assume policy credibility,

behaviour in the ways I have touched on. Indeed,

In fact, credibility is not something that can just be re-achieved, by policymakers — through our actions,

and reasoned explanations of them.

assumed. It has to be achieved, and continually

For that reason alone, policy inevitably remains a

judgemental process — not one mechanically tied to a

particular model, but one that draws on a wide range of Ltheearnneixntgfeisw, aycecaorrsd, ifntghlye, ienchoenroemnty ienscoauprems ibsesiong. Over

buffeted by shocks, we will learn quite a lot. In the

inputs, including the insights of our b sine contacts.

antime, notwithstanding the uncertainties, we have to

make judgements and explain them.