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Monetary Policy Issues: Past, Present, Future – Speech by Stephen Nickell

A shortened version of this paper will be given as a speech by Steve Nickell at a lunch organised by Business Link and the Coventry and Warwickshire Chamber of Commerce in Leamington Spa on 19 June 2002.

A summary of the paper

1. Has the MPC demonstrated a bias towards deflation?

The answer is no. Over the period 1999 Q2 to 2001 Q1 inflation undershot the target and would still have undershot the target even if interest rates had been set ¼ point lower during the relevant decision period 1997 Q2 to 1999 Q1. But the MPC over this period could not reasonably have been expected to predict the rise in sterling and the modest wage growth which generated the undershoot. Over the more recent period 2001 Q2 to 2002 Q1, inflation again undershot the target but this time, had interest rates been set ¼ point lower during the relevant decision period, inflation would have overshot the target. More generally, the fact that MPC decisions are found to be only a fraction away from optimal with the benefit of 20/20 hindsight looks like something to celebrate.

2. Can we expect a surge in productivity growth because of the New Economy?

The answer is probably not. Since 1995, the US has seen a boom in IT-related productivity growth. The UK saw no such boom, despite a high level of IT investment. While the UK/US productivity gap, which had been closing since 1980, was still quite wide in 1995, it is even wider today. So why do we believe that the UK is unlikely to start catching up any time soon? Basically, because of a number of structural problems. Relative to the US, the UK has lower levels of R&D spending and innovation, lower levels of competitive pressure on firms and specific weaknesses in general management skills and in post-school vocational education. Some of these problems are the subject of systematic policy attention, but it will take some time before any results start to show through.

3. What is the significance of the "imbalances" in the UK economy?

We consider three: (i) Consumption growth, debt and house prices; (ii) Domestic demand growth and the exchange rate; and (iii) Weak manufacturing and strong services. We conclude as follows. First, it is reasonable for consumers to take on higher levels of debt in a low inflation, low interest rate era. At some point, the transition to higher debt levels will end, with consumption growth slowing as a consequence. There is no strong argument for the MPC to respond specifically to the current levels of debt over and above the response required if the consequent high levels of consumption growth leads to excessive inflationary pressure.

Second, with regard to house prices, there is no reason for a special increase in interest rates simply to "cool the housing market". The MPC should act if and when the impact of rising housing wealth on demand is such as to push the inflation forecast above target. Generally speaking, it does not have enough information to follow a policy of pricking potential asset price bubbles, en passant.

Third, the fact that domestic demand growth has been stronger than output growth for some time has put some pressure on the balance of payments. Recovery in the world economy will reduce the current account deficit as will the prospective slowdown in consumption growth when it occurs. This process may or may not be associated with a permanent fall in sterling. However, whether sterling falls or not, there is no reason for the MPC to react to any possible inflationary consequences of such a fall until it actually happens.

Fourth, there has recently been a dramatic contrast between expanding services and contracting manufacturing. The gap in growth rates between the two has been particularly wide because sterling is strong and the world economy has been weak. However, services growing faster than manufacturing is the normal state of affairs. Since the mid-1960s, an average of 125,000 manufacturing jobs have disappeared every year while a higher number of jobs has been created in other sectors, notably services. So when the world economy recovers, the gap will narrow but not disappear. Furthermore, monetary policy has no special role here. This is more the concern of regional and industrial policy.

4. What are the challenges for the immediate future?

In the latest Inflation Report, the MPC produced a central projection for a strong recovery in the UK with GDP growth above trend by 2003 and inflation rising above target at the end of the two-year forecast horizon. A mechanical rule which translates the central projection of inflation at the two-year point into an immediate interest rate adjustment would have generated a rise in rates in May. But such a mechanical rule is not the best way of keeping inflation close to target. While it may take two years for interest rate changes to have their full impact, there is some impact well before then. This obviously means that a rise in interest rates further down the line would still impact on demand early enough to lower inflation to the target level at the end of the two-year period and beyond. Given the fragile and uncertain nature of the UK recovery, some delay in raising rates was the correct strategy for keeping inflation close to target over the long haul.

Key Resources

Monetary Policy Issues: Past, Present, Future - Full Speech

http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2002/speech173.pdf