Interest rates today and the economy in the longer term

Speech by the Governor[1]

- *Some may argue that the recent rise in interest rates was too large. But short-term rates have been exceptionally high in many countries for two years, and there has been a steady upward march in long-term rates. Even now, rates in this country are no higher than the international average.*
- *Some reduction in the exchange rate was acceptable for its impact on industrial competitiveness. But to have sought to hold our short-term interest rates below the levels markets were signalling as appropriate would have risked unacceptable depreciation, with major effects on domestic costs.*
- *While a monetary target provides a necessary discipline, in the short term our actions need to be guided by a range of considerations. To give weight to exchange rate considerations would on some occasions have meant loosening monetary control: in present circumstances, pursuit of the two objectives has been complementary and mutually reinforcing.*
- *The prospect is one of gradual recovery. We must make use of this period of recovery to get inflation to quite small numbers and keep it there.*
- *The gains achieved in industry during the past two years are potentially large. This year there has been a marked increase in manufacturing productivity, and unit labour costs have risen little—less than for nearly a decade, and less than for many of our competitors.*

My task tonight, My Lord Mayor, is to add my contribution to the assessment of the economic position of our country. I shall begin with, and indeed concentrate on, the monetary dimension, as is appropriate to my responsibilities, but I shall later have something to say about our position more generally.

Against the background—now visible practically worldwide—of inflation, slow growth, unemployment and violent fluctuations in financial markets, it is clear that we, and in their degree others, are in the midst of stubborn economic difficulties. In particular, the recent sharp increases in interest rates in this country brought widespread disappointment and concern.

For many businesses this must seem especially hard at a time when profits are still acutely depressed. Equally, to householders buying their own houses, at a time when local rates are soaring, the rise in mortgage rates must seem harsh and unwelcome. Of all this I am keenly aware.

The present position of monetary policy

What I then have to do tonight is to give you the reasons why our monetary policy had to be what it has been. I shall do this, not in theoretical terms, but in terms of the obvious considerations which the Bank cannot neglect if it is to discharge its central and time-honoured responsibility—the responsibility, not least in today's unsettled climate, to seek to protect the integrity of the nation's currency, both domestically and internationally. That objective is constant. Means may vary with changing circumstances, but this end must be resolutely pursued whatever the environment; it is a pre-condition for the effective functioning of the economy. The events of recent weeks have provided a dramatic example—but not an isolated one—of the forces with which we contend in seeking to hold to this purpose.

To understand more fully the situation we faced I must ask you to take your minds back to the early months of this year. You will recall that at the time of the Budget we found it possible to reduce our interest rates, on both domestic and external considerations, to levels which were indeed low by international standards. Our possession of oil provided a special source of strength for our own exchange rate. Our European partners had, however, even before that time felt the full force of high US interest rates and had been compelled to react to protect themselves against the inflationary impact of depreciation; but sterling was still relatively sheltered, and our interest rates remained unaffected and relatively low. The exchange rate, it is true, declined from its high points both against the dollar and in trade-weighted terms; but some reduction was acceptable for its impact on industrial competitiveness.

As the year went on, however, the pressures on the exchange rate tended to increase, in response in the first place to the weakening of oil prices. Developments in the United States, at the same time, widened the differential in interest rates against us.

(1) Delivered at the Lord Mayor's dinner to the bankers and merchants of the City of London on 15 October 1981.

At home the domestic situation produced conflicting evidence. The prospect for inflation, and developments in the real economy affecting it, did not on their own point clearly to restrictive action. At the same time, the growing pace of bank lending to persons had to be viewed alongside a lack of buoyancy in retail sales and the housing market—developments not unconnected, it seems, with the concurrent pressure on real income. But the growth of the money supply, though increasingly obscured by the Civil Service dispute, gave signs of accelerating, and pointed in the same direction as concern about the exchange rate.

The course of interest rates depends not only on the actions of the authorities, but also on market forces—and this was true under the earlier arrangements no less than under the more flexible method of operation we adopted in the summer. Even while minimum lending rate was still in operation, the markets in August—in the face of the pressure of international rates—were indicating that our own interest rates would need to go higher. While we leant against this tendency, external market pressures steadily mounted—to a point, in mid-September, where further resistance appeared inappropriate in view of the course of the exchange rate, and the fact, also, that the evidence of domestic monetary trends had become more insistent. The first stage was that we had to shift our own dealing rates moderately higher. The second stage, following the world-wide spasm in financial markets, swept our short-term rates still further upwards.

I know that some may argue that the rise in interest rates was too large; and that this is especially hard for industry at a time when demand is weak, profits are low, and the exchange rate—though lower than it was—still leaves many firms with a stern struggle in facing foreign competition.

But what was the alternative? What would have happened if we had ignored the pressure in exchange markets and had sought to hold our short-term interest rates below the levels that markets were clearly signalling as appropriate? The answer must be that we would have risked provoking a quite unacceptable degree of depreciation—unacceptable because it would have had major effects on the level of our domestic costs. When confidence is disturbed, and in the absence of firm action by the authorities, markets can easily generate a momentum of their own. An exchange rate can then be carried down to a point where the authorities are forced in the end to react. Experience shows that this usually involves interest rates higher than ever and often lasting longer than might otherwise be necessary.

The international background is thus a crucial aspect of our situation. Short-term rates have been exceptionally high in many countries for two years and more, and there has been a steady upward march in long-term rates. The increase has been in real as well as nominal rates. Any reasonable computation shows a marked movement in virtually all major countries as compared with the decade of the 1970s. It is worth asking ourselves what the reasons are.

Part of the explanation, of course, is simply an overdue adjustment to the high levels of inflation. But high interest rates also reflect the fact that countries everywhere have now given priority to beating inflation and seek to control the monetary aggregates. The effect of the actions of the authorities is most apparent in the case of the United States. This is not, however, the whole story. In large part the rise in rates reflects something more profound—a reaction to the uncertainties of our modern world and, in particular, to the power of inflationary forces now at large.

To greater or lesser degree all countries are now experiencing these pressures. It is not possible for us to insulate ourselves from them. In real terms, even after their recent rise, interest rates in this country are now no higher than the international average. International interest rates over the last week have edged downwards, following developments in the United States and helped also by the realignment within the European Monetary System—moves now reflected in our own banks' base rates.

In the light of this account, it is clear that our resolve to pursue the path of financial discipline has manifestly not weakened. But it may be asked, My Lord Mayor, how we now view monetary targets, of which we have had five years' experience since their first adoption. A monetary target, for all its difficulties of interpretation, here and elsewhere, provides a necessary discipline. But in the short term our actions need to be guided by a range of considerations. Last year, with the economy moving sharply into recession, money supply on the broad definition grew very rapidly, yet policy was evidently severe—as was clearly shown by the other aggregates and the exchange rate, then very strong. This year, we have had the prolonged statistical fog created by the Civil Service dispute; we have had to consider the growth of bank lending at a time when demand in the markets to which the credit has gone has been weak; and we have had the decline in the exchange rate.

Despite these complexities, it remains imperative to keep the rate of monetary growth under control. To give weight to exchange rate considerations would on some occasions have meant loosening our monetary control. But in present circumstances pursuit of the two objectives has been complementary and mutually reinforcing. The fundamental objective remains that of providing a financial climate in which inflation can be progressively brought down, and preserving a stable base from which expansion of the economy can be progressively resumed.

The position of the economy

As the last part of what I want to say this evening, it is right to look more broadly at the position of the economy, and to add my own comment on the situation. Though recession has at least ceased to deepen, I do not wish to disguise our difficulties or to suggest that the situation will be quickly transformed.

It is scarcely surprising that, with output depressed and substantial unused human and physical capacity, so much attention focuses on the possibility of early recovery. But it is difficult to predict accurately the future course of output or say how soon recovery will come.

What seems to me more important, and more fruitful, is to take stock of some of the gains which I suggest have been achieved in industry during the past couple of years. These are potentially large, and perhaps not adequately appreciated. Some important foundations have been laid.

In doing so, it is, I suggest, right to recognise the major changes taking place in the economy. I am struck by the multiple sources of the adjustment now under way. There is the adjustment to our possession of oil. We still have to adjust fully to the higher price of energy; to the competition of the newly-industrialising countries; and to the quickening pace of technological advance, in particular in electronics. Beyond these, there is the adjustment made necessary by the recognition that policy is deliberately fashioned not to permit the continued momentum of the inflationary process—so deeply entrenched in economic, social and political patterns. The process of an adjustment on this scale must surely be protracted, and the prospect we may need to see before us is a process of gradual recovery.

We must make use of this period of recovery to get inflation progressively down. Monetary policy must continue to provide an appropriate restraint on the course of money incomes, as an anchor in an inflationary world. But the aim of policy is to cut back inflation, not real growth. The scope for real expansion will in practice depend very much on getting inflation down to quite small numbers and keeping it there. Success in the dual task of defeating inflation and securing real recovery thus rests on better productivity and responsible pay bargaining as much as on a responsible monetary policy. Success will also require an altogether new degree of flexibility in labour markets and in employment practices.

There are some encouraging signs. Wage negotiations and wage settlements have been more closely related to what firms can pay; and there have been far fewer strikes.

Moreover, while the prices that industry pays for fuel and raw materials have sharply increased this year, retail prices have not, so far at least, accelerated in face of these higher costs. The reason is, I think, significant. Labour costs account for half the input costs of British industry; and the rise in unit labour costs in manufacturing has been a major inflationary influence over the past decade. The task of getting inflation down depends critically on success in this area. This year there has been a marked increase in manufacturing productivity, all the more remarkable for occurring at the bottom of a recession; and, as a result, unit labour costs have been virtually steady. Indeed, the very small increase in the first half of this year was the smallest in any comparable period for nearly a decade and seems to have been below that in many of our major overseas competitors. We have made a beginning. We have done better. But we need to do more to restore the competitive position which was so heavily eroded over the previous two years. And there is equal need to restore profitability to our industry.

This encouraging improvement in productivity reflects great efforts. Tighter manning levels have been achieved, overheads have been reduced, stock control improved, and investment projects subjected to closer scrutiny. In general there has been, I think, a tautening of management, and an improved understanding at all levels of what competition means. It is difficult to know what part of this gain will prove temporary, and what part represents underlying progress in bringing our performance more closely into line with best practice elsewhere. Companies that hold on to their gains and improve them further will clearly fare better than those that allow them to be lost. I am optimistic enough to believe that many of the gains can be permanent.

Conclusion

My Lord Mayor, it is my own task to guard the stability of our finances to the best of my ability in a world that is not always ideally shaped to our desires. I hope like all of you that the sharper edges of our situation will become less sharp. I have not sought to offer easy solutions, but yet I have sought to indicate a hopeful way ahead. Industry has accomplished more in recent years than is readily apparent or credited, and we should take encouragement. For whether recovery is quick or slow, more remains to be done. Effective effort will I am sure have its reward—as in our individual concerns, so on the scale of the nation.