Monetary policy in the second half of the 1980s

*In a wide-ranging review of monetary policy over the past few years, the **Governor** examines*[1] *the roots of the recent resurgence of inflation in the United Kingdom, acknowledging that policy mistakes and forecasting errors had played a part in it. He goes on to discuss a number of measures sometimes advanced as alternatives to high interest rates, highlighting their limitations and potential disadvantages. He concludes that there was no real alternative to tight monetary policy, which was a necessary correction of earlier laxity, and that counter-inflationary policy is again on course and will re-establish the basis for future prosperity.*

The Bank's utterances—maybe especially Gubernatorial utterances—are often alleged to be in Delphic code.

I intend to try to give the lie to such assertions this evening by speaking very plainly about recent monetary policy. I shall, of course, defend it—but it is clear from the rise in inflation over the past two or three years that something has gone quite badly wrong, and I shall not deny that policy mistakes and forecasting errors played a part. Inflation is now higher on most measures than at any time since 1983, so that a sense of disappointment is certainly in order, as is a sense of urgency in reversing the recent slippage.

It is perhaps hardly surprising that policy makers have recently come in for some fairly tough criticism. But it is not always clear just what our critics believe we should be doing.

Inflation matters

I should open, however, with some remarks on why inflation actually matters, but I shall not devote much time to this because, frankly, I do not think we will have any disagreement about its evils.

The key problem with inflation is the uncertainty it creates. In theory, if the level of inflation could be foreseen, it could be discounted—that is to say, we could modify our behaviour to take account of it. But, as we all know, it is impossible in practice to forecast inflation accurately. Furthermore, while *in principle* the risks created by inflation could be reduced by hedging instruments, these have not been much developed in practice.

The higher the inflation rate, the less stable it is likely to be; and the less stable the inflation rate, the greater the uncertainty that is generated. The upshot is that contracts are written, and behaviour is modified, to minimise the effects of the uncertainty. In other words, we find ourselves worrying about how to protect wealth, rather than how to create it.

Zero inflation is likely to be more stable and credible than any other level—and more consistent with a society where contracts mean what they say and the financial system supports enterprise.

It may well be that, at any given moment, zero cannot precisely be achieved. But as Alan Greenspan recently put it, 'For all practical purposes, price stability means that expected changes in the average price level are small enough and gradual enough that they do not materially enter business and household financial decisions.'

Uncertainty about inflation—and thus future price levels—is very damaging to the proper functioning of the economy. With a steadier general price level, individual price signals can be read more clearly. More rational decisions can be taken about whether to save or whether to borrow, whether to invest or whether to consume, and what or when to produce. In short, it provides the necessary context for resources to be effectively deployed. This is the very basis of a market economy.

But I do not think it is necessary to rest the counter-inflationary case on sophisticated theoretical arguments. There is an easier approach, which is to look at the run of events in a practical way. In the 1970s inflation was consistently high, averaging 12% per annum; and company profitability was squeezed, falling from about 10% in real terms at the start of the decade to not much more than half as much in the late 1970s, setting aside the effects of oil. This contributed to progressively rising unemployment.

It was clear that we could not carry on like that and the recession of the early 1980s was necessary to break the previous inflationary psychology. As a result, unemployment has, on average, been higher in the 1980s. But from 1981 to 1987—when underlying inflation was falling—profitability rose; net investment in the whole economy more than doubled; and, following the initial shake-out, unemployment has recently almost halved, despite a very rapid increase in the size of the labour force. Our economic performance improved out of all

(1) In the University of Durham and Tyne and Wear Chamber of Commerce International Celebrity Lecture, at Durham Castle, on 5 April.

recognition as inflation was brought under control by a firm non-accommodating policy stance, and the recent setbacks must therefore be all the more disappointing to the business community.

To sum up so far then, I take it as axiomatic that inflation matters, and that it is in industry's interests, as well as the interests of the wider economy, that it be reduced until we can think of price stability as a reality in our lives.

Criticisms of current policy

Agreement on this unambiguous and essential goal of economic policy does, of course, leave plenty of room for argument about how it is to be reached. You will all be familiar with the complaint that excessive reliance has been placed on interest rates, with the result that, at 15%, they are simply too high.

Before continuing, however, I should just note that the level of interest rates is very substantially moderated, both for most lenders and for industrial borrowers, by inflation and the tax regime: it is the net real rate that bites.

The net real rate *is* still higher than we have experienced for much of our recent history. But I would suggest that it is not outrageous. Indeed, it remains modest compared to measures of industrial profitability.

In any case, there can be *no* doubt that lower interest rates would add to the inflationary pressures in the economy in a number of ways. They would increase debt-financed spending, and thus domestic demand. And by weakening sterling, they would also directly increase the prices of imported goods and industrial inputs. The lower exchange rate would, in the short run, improve British competitiveness in both export and home markets; but with a high level of overall demand, this would tend to reduce employers' ability to resist wage pressures and thus undermine the cost base of industry in the longer term.

By fuelling higher inflation, lower interest rates would not even be sustainable, since nominal rates would sooner or later have to rise to compensate for the deterioration in the value of money.

Some of those calling for lower rates may well accept this, but at the same time believe that the consequences could be avoided by other measures—I shall come to that later.

Roots of current inflation

Instead, I want first to argue that the roots of the recent resurgence of inflation have been essentially financial and substantially monetary, and have therefore called for a corresponding monetary response.

Before it became apparent that we had a very serious inflation problem on our hands, it was pretty clear that domestic demand was growing at an unsustainable rate. I say only 'pretty clear' because over the past three or four years there have been significant discrepancies in the official statistics and material revisions to them, which has made interpretation difficult.

In particular, the output and domestic demand statistics for 1987 and 1988 have been consistently revised upwards, with cumulatively very substantial results. This is one reason why policy has not seemed impressively effective.

To slip into a rather hackneyed metaphor, we put the brakes on when the speedometer indicated we were doing 60mph. Some time later it said we were doing 55. When the tachograph was opened, however, it revealed that we had actually been doing 70 when the speedometer read 60. Thus the problem was *not* that the brakes were ineffective but rather that the speedometer had been misleading. And more brake pressure was therefore entirely appropriate.

Although we did not know just how fast domestic demand and output were growing, we *did* know that demand was running away from output. This was made plain enough by the deterioration in the trade balance.

So there was excessive demand and, as I need hardly say, excessive demand growth has inflationary potential. Attempts to meet it from domestic sources eventually encounter bottlenecks and competitive bidding for scarce skills, which are liable to spill over into pay and costs more generally.

The inflationary damage emerges only after some delay, however. It seems to me that, because of this, those who now complain about high interest rates were not uncommonly those who applauded the earlier measures that created our problems. William McChesney Martin, Chairman of the Federal Reserve Board in the 1950s and 1960s, said that it was the duty of a central banker to take away the punch bowl just as the party was hotting up. So it is; and he cannot expect to be thanked for it. But any criticism of his attempts to clear heads the next day should take the form of a remonstration that he was not firmer the night before. Candidly, I think such criticism is far too rare.

Although I have referred to statistical difficulties, those merely made the job more complex. The root of the problem was a consumer boom, which coincided with strong—and very necessary—growth in investment spending.

But why did consumer spending grow so much faster than disposable income?

It seems to me that there are a number of connected factors here. The starting point may have been the rebuilding of consumer confidence as we recovered from the 1981–82 recession. This was rather more than a merely cyclical recovery and involved increased optimism about *long-term* growth prospects. Once people were confident that earnings were likely to rise year by year, they were more prepared to borrow and spend larger amounts, even though the higher incomes they expected

were not immediately available. Such a shift implied a fall in saving. Moreover, the extra demand and the confidence itself, if shared by companies, was also likely to lead to an investment boom, so that domestic demand outstripped output, pushing the current account into deficit and putting upward pressure on prices.

I think this is a reasonable portrayal of what happened, and if nothing else it shows the fatal dangers of over-confidence.

But the other key ingredient was that the increased spending was so easily financed, on account of a massive increase in the availability of credit, whose roots can be traced back to the lifting of a series of restrictions on lending institutions in the early 1980s.

The immediate impact of this liberalisation was rapid credit growth, but this was initially mostly absorbed in a restructuring of portfolios. This was neither unexpected nor, of itself, undesirable. The combined effects of inflation and the earlier restrictions on access to mortgages had, for example, reduced the stock of mortgage debt to a relatively low proportion of the value of the housing stock. Liberalisation led to the restoration of a more normal relationship, while the extra funds were redeployed in various ways. The key point is that, at that early stage in the process, the personal sector remained in financial surplus—that is, in aggregate, individual acquisitions of financial assets exceeded their additional liabilities.

Eventually, however, the restructuring of portfolios gave way to less neutral activities—and forecasts as to how far the borrowing would go were decisively proved wrong.

The personal sector collectively went into deficit on a considerable scale, depressing the savings ratio—by which I mean the net ratio, or gross savings less borrowings and investment, divided by personal income—to levels not seen since the 1950s.

Furthermore, house prices had been bid up to *unprecedented* multiples of earnings, especially in the South East.

This in turn had the effect of releasing funds for spending through equity withdrawal. It became much easier to use houses as collateral for loans spent not on building—which has little import content—but on cars, video recorders and other durables, many of which were imported or would otherwise have been exported.

Behind these nationwide patterns, there were strong regional variations. The housing boom rippled out gradually from the South East, so that house prices here in the North were rising rapidly after the tightening of policy had halted the rise in the South.

It might be thought striking that the adverse impact of the recent tightening of policy on the prosperity of the North has so far been relatively limited.

But in part, this is precisely because the heavy borrowing and inflated house prices were concentrated in the South. Moreover, in sharp contrast to the early 1980s, high interest rates have not coincided with a strong pound, so that the profitability of manufacturing industry, which tends to be based outside the London area, has to an extent been protected by its international competitiveness.

As I have told the story so far, the developing credit boom of the 1980s owed more to increased confidence and general decontrol than to low interest rates, but of course this is by no means the whole story. First, the controls which remained in place during the early 1980s rationed some people's access to credit, and thus had some of the same effects as raising interest rates, since some potential borrowers were denied access to credit for which they might have been willing to pay a high price. Relaxing the controls lowered this 'shadow price', and was therefore analogous to a reduction in interest rates.

Moreover, actual interest rates were reduced over a period during which we now see they clearly should not have been.

The fact of the matter is that, in the net real terms I mentioned earlier, rates became very low, although, unlike the 1970s, they were still positive. To those who complain that rates have risen too much, I would reply that it was absolutely necessary to get away from such unrealistically—and ultimately damaging—low real rates.

Possible alternative policy responses

I mentioned earlier, however, that some who argue for lower interest rates claim that alternative measures are available. Indeed they *have to* make that claim if they are to avoid the accusation of being soft on inflation.

(a) Credit controls

Credit controls loom large in many agendas. And one *can* see why they might be tempting. If, as I have suggested, the relaxation of controls had similar effects to reducing interest rates, would it not be possible to reverse the process by reimposing controls? There are three answers to this—all, I am afraid, discouraging.

I have little doubt that the first point is very familiar. The clock simply cannot be turned back to the late 1970s. Exchange controls have gone, and even if we wanted to reimpose them—which we do not—we could not do so do *vis-à-vis* European Community countries. Any credit restrictions could therefore be circumvented by going offshore.

Maybe this would not happen immediately but, quite frankly, businesses would quickly provide facilities so that one could buy a car in, say, Dusseldorf on credit, even if HP controls applied in Durham; and bank finance could be arranged in Paris or Amsterdam without leaving home.

As well as reducing the effectiveness of controls, it would reduce their equity, since the unsophisticated would be the main sufferers.

The second problem is, indeed, that credit controls would discriminate unfairly between borrowers, as they would in effect be equivalent to differential interest rates. Some people would have access to relatively cheap credit, while the rest would have limited access, if any at all. This is likely to be socially unjust and is certainly economically inefficient since some of the lucky would be able to satisfy less urgent needs than those of some of the frustrated.

The third potential difficulty with credit controls is a little more subtle. Even if one allows that credit controls *would* have some temporary effect, even in the absence of exchange controls, the promise they hold of getting us out of a tight spot can be illusory, since it would be extremely difficult to judge when to lift any controls, and indeed to have the courage to do so. No doubt one would go into the enterprise with the attitude that 'when the clouds lift, as they will soon, the controls can be removed'.

But, in practice, I suspect the clouds rarely lift enough. It would be said, 'to abolish the controls would send the wrong signals, although the situation is no longer critical, we are not yet out of the woods'.

The point is this: such addictive drugs *do not* represent a good bargain for anyone.

(b) Reserve ratios

Leaving aside direct controls, I should digress slightly to recognise the occasional suggestion that the central bank has another magic wand available: reserve ratios. I do not want to go into this in detail but, since there seems to be some confusion here, I should just say that such requirements, which we *have* used in this country in the past, are *not* credit controls in the usual sense. They work through their effect on money-market interest rates, and would not therefore provide an alternative to interest rates, simply an alternative—and an unnecessary one—to our existing methods of influencing interest rates. Our critics may argue that we have raised interest rates too much, or too little. But I do not think they can say we fail to influence rates when we want to.

(c) Funding policy

Another suggestion that is sometimes made is to load more of the burden of adjustment onto *long-term* rates. This proposal looks back to the period when the government was a heavy borrower in the gilt-edged market and indeed to the phase of *over-funding* when the government borrowed substantially more long term than it needed to finance its deficit.

The effect of this, so the argument runs, was to push up long-term yields and to hold down the growth of broad money, so that, by one route or another, the growth of demand was restrained.

More recently, of course, the government has had no deficit to finance. In these circumstances, the equivalent of old-style over-funding would be to buy back less stock than the value of the surplus.

In fact, policy has instead continued to be guided by the 'full-fund' rule, with government debt being bought back on a scale equivalent to the surplus. Would it not have been a good idea, we are sometimes asked, to employ the surplus in some other way?

There are a number of points that can be made against this. First, the case for over-funding depends on there being a robust and predictable relationship between the behaviour of broad money and the level of demand. There was indeed a time when we thought that this relationship was such that managing broad money *did* provide a reliable indirect means of managing demand, and thus inflation. But developments in the first half of the 1980s, including the deregulation I referred to earlier, led us to abandon that view, and nothing since has persuaded me that a firm relationship has been re-established.

The second difficulty is that funding—or rather over-funding—has in any case become a less than effective means of managing broad money. While there are various accounting relationships that suggest that this might be straightforward, in fact in the real world we have to take account of the behaviour of other users of the capital markets. In contrast to the early 1980s when the private sector made very little use of the sterling capital market, it has, not unexpectedly, exploited the opportunity to tap the market for funds since the government ceased to be the dominant borrower; indeed, 'crowding out' has been replaced by 'crowding in' on an impressive scale. In consequence, the absence of government funding has arguably had less of an effect than might be expected on the growth of broad money. And, by the same token, there has been a smaller effect in terms of holding down longer-term yields.

It is, however, important to recognise that to the limited extent that longer-term yields were held down, that was quite welcome. It helped to ensure that the burden of the adjustment of demand was more concentrated than it would otherwise have been on spending sensitive to short-term interest rates rather than on spending sensitive to longer-term rates. In other words, while personal spending—which has been the root of our problems—has been restrained, much corporate investment was allowed to continue.

More recently, despite the continuation of the same policy towards funding, long yields have risen quite sharply. This has been a global phenomenon, associated with the prospect of substantial new demands for capital as a result of the political changes in Eastern Europe. The effect in the United Kingdom is likely to be some dampening of

investment activity, not in itself desirable but helping to restore a better balance between demand and supply in the economy.

(d) Fiscal policy

Some critics accept that credit cannot be directly controlled to advantage and do not counsel reserve ratios or over-funding, but nevertheless maintain that the burden of securing the desired adjustment has fallen too much on monetary policy—and particularly interest rates. Could the 'one club' of interest rates usefully be supplemented by fiscal measures?

The answer is unequivocally 'yes'. But, let me equally stress that fiscal policy *has* supported monetary policy. The allegedly exclusive dependence on monetary policy has been greatly exaggerated.

Fiscal policy has been consistently tight over recent years. Not long ago a PS*B*R of 2% of GDP was seen as a satisfactory long-term norm; in 1989 the PS*D*R was getting on for 2% of GDP. Efforts to do more via fiscal policy would take us down the road of fine tuning, whereas this part of government policy has, rightly in my view, been directed towards medium and long-run goals.

There is, of course, also the more specific accusation that taxes were reduced inappropriately in the 1988 Budget. However, not only was this consistent with the tightening trend I have described, but the injection was totally overshadowed by the expansion of credit; credit exceeded any direct fiscal effect by several times.

Even if *all* the increased disposable income had been used to secure additional net debt, so that tax cuts could be blamed for much of the extra borrowing—which is most unlikely—it would not account for the whole, and on that basis alone the boom could not have been sustained.

So far I have explored four conceivable ways that might be advanced for reducing our dependence on the interest rate weapon in managing the domestic economy. There is a further problem affecting all of them on account of the role played by interest rates in relation to the exchange rate, which is of course important to the control of inflation. Even supposing domestic demand management *could* satisfactorily be achieved at a lower level of interest rates, it might not be possible to reduce them if there were a risk that the exchange market would be unsettled. In other words, the employment of other measures would not *necessarily* result in lower interest rates.

(e) ERM membership

There is one measure, however, which could play an important part and which the Government is committed to employing in due course: membership of the ERM.

Would the trade-off be very different if we were members of the ERM?

It might possibly be—but not in a business-as-usual spirit. If membership is to mean anything, realignments would have to be regarded as a last and not a first resort. It is possible but by no means certain that, within the ERM, lower interest rates would not immediately depress the currency, in which case inflationary pressures would not make themselves felt immediately. Any excess of the growth of sterling unit labour costs over deutschemark or French franc unit labour costs would represent a loss of competitiveness.

Thus, while the ERM could constitute an alternative discipline, it would not be a soft option. The plain fact is that nominal wage increases have to come down. You do not need me to tell you that this is not easy. But if the knowledge that the exchange rate would not be allowed to depreciate helped focus the attention of both sides of industry on the fundamental determinants of competitiveness, then ERM membership could be beneficial.

One key to the success of membership will therefore be the impact on behaviour in the real economy, as well as the reaction of financial markets. But as we all know, both the timing of our entry and the rate at which we join are critical to its efficacy.

The current adjustment

Let me now turn to the present adjustment. It cannot be said that we have not made any progress. On the contrary. We have reduced the growth rate of consumption from 8% per annum in 1987–88 to about 2½%. And the growth of domestic demand has fallen sufficiently below that of output for there to be a general consensus that our current account position will improve substantially this year.

Inflation itself is, sadly, the item we would expect to respond last. This is for two reasons. Wage increases typically, and unsurprisingly, reflect conditions in the labour market, particularly unemployment and vacancies. In a boom, firms cannot recruit and train fast enough, so that they work overtime and run down stocks. When demand slows, for a while they *go on* hiring to rectify these imbalances, and slack emerges in the labour market only rather late in the day.

Second, the mortgage rate element of the RPI pushes up this price index—which is the one of most concern to wage bargainers—precisely when policy tightens. Thus, the policy signal that lower settlements are needed can be muted by continued hiring and the message from prices. And in our immediate situation, there are a number of administered price increases, required to meet other policy objectives, which will delay the fall in the RPI.

The adjustment underway is bound to involve some pain in the form of slower growth.

But industry is in a rather different position compared with the early 1980s. For a start, it is not handicapped by an overvalued exchange rate.

As the excessive demand placed on our productive capacity has eased, manufacturing in particular has been able to respond well to its present competitive position. Indeed manufactured exports have risen faster than Japanese exports for three years now and grew by over 10% last year. This performance represents a return on the substantial investment made by industry, not only in new plant and machinery and more research and development, but also in the painful process of reorganisation and restructuring.

Supply-side improvements

The other main difference—which is perhaps more profound—is that manufacturing is simply performing more effectively. This has, I would suggest, been helped greatly by the supply-side reforms of the past ten years.

There can be no denying the pain that was suffered in the early 1980s. But that management and the workforce are now operating more realistically is indisputable and, if I may say so, a credit to all concerned.

The greater responsiveness and competitiveness of industry as a result of productivity growth is one reason for believing that the effect of slower growth of domestic demand on industrial output could, after an initial period of destocking, be quite limited. And at current profitability, the setback to industrial investment could also, I hope, prove shortlived.

If lower growth of domestic demand is not to bring about recession, we need to raise net exports of tradables and to restrain the rate at which the prices of non-tradables—particularly services—rise.

The service sector, which less easily switches its output into net trade, has been in the lead in both borrowing and raising wages, and I suspect may therefore prove less robust than manufacturing. Furthermore, services have a large labour content, and their prices therefore necessarily tend to follow wages.

The flexibility of the labour market is therefore crucial.

I recognise that house prices—and particularly regional variations—have an impact on this. But, however regrettable this may be in social terms, it is vital that people recognise the added reason for abandoning rigidly uniform national wages. Regional pay should reflect specifically regional factors—such as housing costs—and the regionally varying balance of supply and demand for specific skills.

There are welcome signs of progress. But it is impossible to exaggerate that increasing flexibility will affect the way that the slowdown in domestic demand is divided between slower activity and slower inflation. The more flexible the economy, the greater will be the fall in inflation and the less the fall in activity.

Supply-side reforms will also affect bottlenecks and skill shortages, which are evident in congestion, particularly, but by no means exclusively, in the South East. There are many authoritative voices demanding increased investment in the infrastructure, including education and training. The amount that might be spent on such projects and programmes is almost limitless and has to be related to the capacity of the economy and the pressures on public finances.

Any infrastructure projects will contribute to domestic demand, whose excessive growth I have stressed underlies our current difficulties. Growth of demand must be cut back. But it would be highly desirable for its composition to shift from consumption to investment—and expenditure on the infrastructure could find its place within this.

The implication of this is that the proportion of income saved will have to rise substantially. There is now some hope of this, and in this context I should say how much I welcomed the Budget measures to stimulate saving. These might particularly spur saving by the less well off, as they should be encouraged by the introduction of the TESSA scheme and the abolition of composite rate tax.

Conclusion

To summarise, I have argued that there was no real alternative to tighter monetary policy, and that it was a correction of earlier laxity.

Its apparently limited effectiveness so far largely reflects the size of the job to be done, which was obscured by misleading information provided by official statistics at the start of the process.

I have set out some of the problems that have beset policy-makers in recent years, and have pointed to some significant mistakes. I have done so because there is no shying away from them; and because such mistakes cannot be afforded again. I believe the policies we have are the right ones; that counter-inflationary policy *is* now again on course; and that it will re-establish the basis for future prosperity.

But we will need to be ever vigilant, and we should not allow the lessons of the second half of the 1980s to be forgotten. Certainly that will be our aim. We must keep our eye on that punch bowl.