Open for business

The then **Deputy Governor** *(now* **Governor***) discusses*[1] *the need for price stability to achieve sustainable growth in output and employment. He cautions that inflation is not dead and that there is some way to go before inflationary expectations will reflect the authorities' commitment to macroeconomic stability.*

I should like to use this platform to speak about the monetary policy environment for business, and, in particular, in a region of green-field sites, to say something about means and ends and carts and horses in relation to policy, because I still find that despite all our efforts these things remain pretty well confused.

Let me start with means and ends. I suppose, Mr Chairman, that central banks have only themselves to blame for allowing the impression to get about that price stability is all that we care about—that it is the be-all and end-all of policy—its exclusive, ultimate, objective. Well I hope I don't spoil your digestion this evening by telling you at the outset that this impression is quite wrong. We are ultimately concerned with the creation of wealth, of employment and higher living standards. To be more exact, we are concerned with creating the conditions in which *you* can achieve these things.

Please don't misunderstand me. As we all know, inflation reduces the purchasing power of money, and does so in an entirely arbitrary way, redistributing wealth between debtors and creditors, between pensioners very often and those in employment, and between the financially more sophisticated and the financially less aware. It is a form of institutionalised theft. I *am*, of course, concerned that our money should be sound—or honest—that the 'promise to pay' on our Bank of England notes should be meaningful in real, and not just nominal, terms. 'Honest' money is an entirely worthy social objective in its own right, and I am not in the least embarrassed to say so.

But there is much more to it even than this. We are every bit as much concerned about the deeply damaging economic effects of variable inflation and we are committed to achieving price stability not just for its own sake, not just because sound money is a social good, but because it is a necessary precondition for the sustainable growth of output and employment, which are themselves necessary for the achievement of other economic and social objectives. In *this* sense 'sound' money is the *means*—and I would argue the *only* means—to that more fundamental *end*. Sound money—price stability—is about jobs and investment; it is about living and welfare standards; it is not just the abstract ideal of a crusty, academic profession that likes to see everyone else dressed in hairshirts.

This may all seem obvious enough (especially, I hope, the bit about a crusty academic)—and if it does then I apologise. But I worry that it is not properly understood, even by a number of commentators who purport to be experts in the field. We still see it reported as news that this or that Minister, or this or that official, has emphasised the need for growth, as if this were some sensational revelation of a change of policy away from the need to achieve and maintain stability. And if they cannot plausibly pretend there has *been* a policy change, then, they say, there *ought* to be and we should 'go for growth' even if that does mean a bit more inflation.

All of this, it seems to me, is a throw-back to the trade-off mentality of 20–30 years ago, when the received wisdom was that you *could* have more growth if you were prepared to live with a bit more inflation. But surely we've moved on from there. It was exactly this approach that produced the stop/go, boom/bust policies of the 1960s and 1970s, and the short-term attitudes—in industry as much as in finance—that have been so detrimental to the long-term health of the economy. It is not at all surprising that at the end of a long and deeply painful recession, there should be a widespread impatience for recovery. But it *is* disappointing that this impatience for recovery should apparently tempt even some serious commentators to forget the lessons that should have been drummed home indelibly by earlier decades of failure. How can lenders or borrowers, or spenders or savers, or consumers or investors, or employers or employees—how can any of them possibly be expected to make sensible decisions if the value of money is likely to decline over time at a wholly unpredictable rate? Why should business invest for the longer term, in productive capacity, in expanding its markets, in research and development or in training, rather than going for quick returns, if demand is likely to be here today and gone tomorrow? And how can business possibly rely upon stable demand conditions if the focus of policy is continuously oscillating between stimulating output and restraining inflation?

Now the fact is that even now there are very few commentators—and very few businessmen, at least among

(1) In a speech at the CBI Eastern Region's exhibition 'Open for Business' dinner at Duxford on 9 June.

those I talk to—who would *openly* challenge the principle. For much the most part, they claim to *agree* in principle that price stability is indeed the necessary means to sustained recovery. The trouble, some say, lies not with the principle, it lies with the practice.

And it is true, we *did* make a serious monetary policy misjudgment in the late 1980s. As in a number of other countries we saw an exaggerated build-up of personal and corporate debt and we collectively failed to appreciate the strength of the associated inflationary pressure. We have paid dearly for that, with both the severity and the duration of the recession flowing directly from it.

But the current criticisms relate to more recent policy—that it was unduly savage during the recession, that it remains too tight even now, and that we could take another point or two off interest rates without damage to price stability—well not too much damage anyway. Behind these criticisms lies a conviction that 'inflation is dead' and that we are continuing to fight yesterday's battle. Like that of Mark Twain, I have to say, frankly, that reports of the death of inflation are greatly exaggerated. Underlying inflation, still today, is running at around 3%–3½% a year, and there is no clear evidence that it will fall further over the next year or so. It was *precisely* because we dropped our guard in 1987/88, in effect settling for inflation below 5% as 'good enough', that we lost control. The battle against inflation *has* to be continuous. The criticism of policy over this more recent period *would* have been legitimate if the authorities had flinched from what was necessary to regain control of inflation and to re-establish the conditions for sustainable recovery, for reasons of short-term popularity. They didn't. As a result, I believe that this country now has the *potential* for an upturn lasting through much of the rest of the decade—provided we are patient enough to *exploit* that potential. This prospect would, certainly, be improved if it turned out that inflation *were* indeed dead. But it would be singularly unwise, in my view, to count on that without much more substantial evidence than we currently have.

If inflation *can* this time be kept under long-term control—and that now depends upon the million and one decisions to be taken by people and businesses up and down the country, every bit as much as upon policy—then there is also the potential for a sustained period of relatively low nominal interest rates. But, sadly, the causality does not run in the other direction—which brings me on to carts and horses.

It is an observable fact that peak levels of interest rates tend to occur—give or take—at about the same time as peaks in inflation, which tend, too, to be associated with the beginning of weakening economic activity and vice versa. I've often, in fact, heard it argued—by people who really ought to know better—that it is the high interest rates that *cause* high inflation and recession—and partial, circumstantial evidence (of the effect on the RPI of mortgage interest costs, and of the effects of bank lending rates on business costs) is duly trotted out. This has the very alluring corollary that *low* interest rates are the key to low inflation and an expanding economy. I don't believe that anyone who thinks about it for very long can seriously imagine that life is quite so simple. Yet, perhaps sub-consciously, this idea seems to underlie some of the current suggestions for a sharply easier monetary policy stance.

It sounds all very straightforward—if you think that inflation really is dead.

But if you don't think that—and the evidence from financial markets, for example from 8% bond yields, is that most people remain to be convinced—then you *might* just worry that bringing interest rates down too far would increase the risk of re-emergence of inflationary pressures, and you might then think that that *might* make lower interest rates difficult to sustain. It is not even certain—in a financial system dominated by variable-rate financial instruments and after the bitter experience of the late 1980s—that borrowing and spending would increase in these conditions, even in the short term. People remember what it was like for those who took out large mortgages—for example—just before interest rates rose.

If people have confidence in the inflationary prospect, and confidence that it will be *kept* under control, then relatively low and relatively stable interest rates will tend to follow. But you cannot simply opt for lower interest rates, regardless of inflationary expectations, and expect them to remain low for very long.

In short, you can't put this particular cart (of low interest rates) before this particular horse (of inflationary expectations or policy credibility). And if you did, you certainly couldn't necessarily expect the poor horse to drink the water (of higher activity), even in the short term!

In a somewhat similar way—as we have seen dramatically demonstrated during the past year—you cannot decree lasting exchange rate stability without *first* having achieved sustainable convergence of economic performance. This applies whether you are talking about the ERM or, still more, about EMU, or, for that matter, about exchange rate stability *outside* any formal agreement.

The ERM in fact achieved remarkable exchange rate stability within Europe over a surprisingly long period before last year, and it provided helpful support to counterinflationary expectations in a number of European countries, including initially—for 18 months or so from October 1990—in this country. But, as the stresses of reunification caused Germany's policy needs to diverge, progressively during last summer, from the domestic policy needs in many other countries in Europe, exchange rates ultimately had to give. Without that, the recessionary forces on the Continent which are already very serious, would undoubtedly have been even worse. And they would have been quite unjustifiably worse, given the progress made towards price stability, to the detriment not just of the Community but of the world economy as a whole. That is something to be remembered by those who are too readily

inclined to fling about accusations of unneighbourly exchange rate behaviour.

There are lots of lessons to be drawn from that experience—both nationally and internationally. It was a salutary warning of the risks of moving too rapidly towards exchange rate fixity—and I share the recently expressed view of the President of the Bundesbank that the target of achieving EMU by 1997 is looking increasingly improbable. Those who hoped that pegged exchange rates would somehow *enforce* economic convergence have perhaps been somewhat disappointed; while others who thought that stabilisation could not be achieved *without* the external discipline of the ERM, will perhaps now be more confident that it can—though it clearly remains true that ERM membership in the right circumstances *can* be helpful to convergence and stabilisation.

For this country the policy lessons seem rather clear—that we could not consider rejoining the mechanism unless and until we are very confident that sustainable convergence between the major member countries really has been achieved; and, in the meantime, that we should continue to pursue the convergence objectives set out in the Maastricht Treaty as sensible guides to the conduct of *national* economic policy. That is likely to deliver as much exchange rate stability between sterling and the deutschmark as we can, for the time being, realistically expect to achieve.

More generally, I would hope that we have learned, from both the more recent experience and from our earlier experience of shadowing the deutschmark in 1987/88, that however desirable exchange rate stability is in principle—and it *is* in principle desirable—it cannot sensibly be bought, or durably bought, at the cost of serious distortion of domestic policy. This is emphatically *not* a call for benign neglect of the exchange rate—it is too important a price, and too important an indicator of possible imbalance elsewhere in the economy, for that to be a realistic option. But, as with interest rates, exchange rate stability has to come as a *consequence* of domestic stability—achieved through appropriate policies overall, including a sustainable balance between fiscal and monetary policy; here, too, you cannot put the exchange rate cart before the domestic stability horse.

Mr Chairman, economic policy management is littered with attempts to reverse the natural order of things across a much wider field, but I will not try your patience further on this occasion.

I want to conclude with some brief comment on the policy prospect for business, which is of immediate relevance to your Exhibition.

Like the Eastern Region, I believe that Britain generally is now again 'open for business', and that is true above all for British manufacturing. Certainly we have been through a cruel recession. But harsh though it has been, the decline in manufacturing output was substantially less than a decade before; profitability in *manufacturing* inevitably suffered—but it weakened from a level that was higher than at any time since the early 1960s and fell back only to levels which were well above those in the trough of earlier recessions; investment in manufacturing was better maintained than earlier experience would have suggested; and manufacturing productivity performance too has been substantially stronger throughout this recession than in earlier periods of decline. Productivity in manufacturing has in fact grown by almost 7½% over the latest year and, with wages under better control than for the past quarter century, unit labour costs have actually fallen by some 3%.

This is a very solid platform from which to move forward. Helped by the lower exchange rate, manufacturing output has already clearly started to recover—by nearly 2½% over the last available three months, and notwithstanding the uncertain economic climate abroad—and especially on the Continent—there is no reason that I can see for this not to continue—as I say—well through the rest of the decade. The potential is very great indeed.

How far we can exploit that potential depends critically on how business itself responds. The significance of the starting point is that there should be less need this time for manufacturing business as a whole to rebuild profitability by snatching at higher margins through higher prices and more scope for expanding market share and increasing volumes. This in itself would go some considerable way towards maintaining the climate of stability which will allow expansion to continue, encouraging investment, including investment from abroad, which continues to be very welcome in this country.

For our part, I have no doubt at all that the Government remains firmly committed to maintaining macroeconomic stability—through the pursuit of its inflation target. And the Government, I think, has no doubt about the Bank's determination to help them in that objective. If we find evidence of prospective increases in costs or prices that threaten the inflation objective we will have no hesitation in recommending the appropriate monetary response.

Monetary policy, Mr Chairman, *is* ultimately about growth, about output and about jobs. But there are no short cuts. Growth—beyond the very short term—can only come about through stability, by which I mean achieving and maintaining price stability; and that is the immediate role that monetary policy can play. It is the necessary condition for establishing the long-term economy which this country needs. And it is the condition that will encourage investment—not least in the Eastern Region. I wish you every success.