Ten years on

The **Governor**[1] *recalls the issues facing policy-makers a decade ago and compares them with those today. He underlines the need for monetary stability and endorses the explicit commitment to an inflation target. He ends on a personal note by reflecting on the debate for giving greater autonomy in monetary policy matters to the Bank and the linked issue of how to provide an appropriate method of accountability within the United Kingdom's constitutional arrangements.*

My first Mansion House speech was in October 1983. On that occasion, with only limited experience of the problems and pitfalls facing a central bank governor, I took the opportunity to look ahead to my term of office. Subsequently my remarks were reprinted in the Bank's *Quarterly Bulletin* under the heading 'The new Governor looks forward'. On this occasion my remarks might be entitled 'An old Governor looks back', for I intend to focus this evening on the operation of monetary policy during the past decade, and the lessons which might be drawn from that experience.

In looking back I am struck by the similarity of the problems facing us then and now. Let me quote from my 1983 speech:

> 'The economy has been through a difficult period: unemployment is high . . . and many companies have been facing and still face difficulties. But we now have low inflation combined with economic recovery, and this offers the prospect of sustained improvement for the first time in many years.
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> Some argue that we can now relax in our battle against inflation, but in my view that would be quite wrong. I speak here from deep conviction, born of my experience in industry and in banking. Sound, long-term investment judgments, essential to lasting prosperity, are possible only when monetary values can be relied upon. Nothing would be more damaging to our prospects than failure to sustain the improvement in inflationary expectations, so painfully won.'

The sad fact that I could use exactly the same words today reflects the principal failure of policy in the intervening period—that we did not keep inflation under control. Yet there has been progress. Inflation is now down to its lowest level for a generation. But our performance over the past decade has not been good enough. Prices have increased by 65% in the past ten years. To be sure, this is considerably better than the 260% increase in the previous decade, but it is still remote from our long-run objective. I earnestly hope that the next decade will be a more comforting one for those living on fixed incomes. There has been a price to be paid for our failure to lock in price stability when we had the opportunity. That price is the successively higher level of unemployment with which we have begun the past three recessions when action was necessary to control inflation. We must learn from that experience, and ensure that, having almost attained price stability once more, we do not let it slip from our grasp.

Lessons of the past ten years

The story of monetary policy over the past decade has been the search for a 'nominal framework'—a framework which not only guides the authorities in the setting of interest rates, but also allows the public to assess whether they are achieving their counterinflationary objectives. We have seen monetary targets (both broad and narrow), informal exchange rate targets, membership of the ERM, and now an explicit inflation target. Why have we changed the framework so often?

The answer to that question makes me think that our current framework, based on an explicit inflation target, is the right way forward. Monetary targets fell victim to financial liberalisation. In my 'maiden' speech I noted that

> 'the way in which different measures of the money supply are related to our national income has not proved easy to predict, but this should not be surprising at a time when the structure of the monetary system is changing rapidly, partly because financial controls have been dismantled . . .'

Financial deregulation was a feature not only of the United Kingdom, but worldwide. And the change in behaviour which occurs in the transition towards a liberalised regime can disturb previously stable relationships between money and nominal incomes. Many other countries have experienced the same difficulties which we in the United Kingdom faced during the 1980s: first, the problem of setting policy when the 'nominal anchor' drifts; and second, the problem of knowing when the transitional phase is over, for at that stage it is possible that money and nominal incomes will resume a stable relationship once more. In retrospect, the search for a nominal anchor contributed to a

(1) In a speech at the Lord Mayor's banquet for the bankers and merchants of the City of London on 15 June.

number of mistaken policy decisions—notably the reluctance to let the exchange rate appreciate. The unsustainable boom in the second half of the 1980s is evidence enough of these mistakes. Whatever the precise errors, there is little doubt that a combination of misleading statistics and inappropriate intermediate targets combined to leave the economy adrift in a turbulent financial sea.

The lesson which was drawn from these events was that the domestic commitment to price stability could be reinforced by a fixed link between sterling and the currency of a country with a good counterinflationary track record. The ERM seemed tailor-made for this purpose, but after we had entered it there emerged an unprecedented disparity between the German and other European economies, especially our own, reflecting both cyclical factors and the effects of unification. This experience—shared by many other countries—showed that counterinflationary credibility cannot be acquired by tying oneself to the mast when the conditions are so adverse that the mast breaks in the wind.

Following sterling's departure from the ERM there were many commentators who regretted the return to the 'judgmental' policies which were held to be the cause of the resurgence of inflation at the end of the 1980s. But we had learnt from that period—and from the experience of other countries—that the establishment of credibility required a willingness both to undertake the necessary policy actions, and also to direct those policies to a specific and well-defined objective. The new policy framework which was put in place after our departure from the ERM is one which will not only, I believe, prove successful and workable in the United Kingdom, but is also one being applied in other countries.

Our model of monetary policy has at its centre the objective of stable prices. This is defined as an average rate of inflation in the long run of 2% a year or less, and a target range for underlying inflation of between 1% and 4% for the current Parliament and to be in the lower half of that range by the end of that period. But, in the absence of any simple and reliable intermediate target, it is vital that the authorities explain clearly and fully why they believe that the policy stance is consistent with meeting the inflation target. That is why we view as essential the obligation on the Bank of England to publish, quarterly, an objective and independent account of recent and prospective trends in inflation.

We have now published two *Inflation Reports*, and the responses we have received suggest that we have indeed begun to satisfy the demand for a comprehensive and authoritative source of information on inflation. We feel it is important that everyone understands the logic underpinning our inflation projections, and equally understands why inflation might deviate from the path we expect. In this respect, the combination of the inflation target and the analysis in the *Inflation Report* enables us to monitor inflationary tendencies in a more sophisticated way than through monetary targets, but at the same time provides a more clearly articulated framework than the judgmental approach of the later 1980s which came to be so heavily criticised. Of course, it is too early yet to be sure that our new model will not crash. But openly and honestly applied I feel confident that it will fly more successfully than its predecessors.

I should like if I may to end on a personal note. I have spoken, somewhat at length perhaps, on the importance of constancy in monetary policy. I know that in Eddie George, I have a successor whose commitment to this is no less than mine and whose experience in financial markets makes him uniquely qualified to secure its realisation—insofar as this is in the hands of one person or one organisation under him. He has my wholehearted best wishes for success.

Mr Lord Mayor, I might well have stopped there. But recent events make it impossible for me not to comment on the current debate on the constitutional status of the central bank. The issue is, of course, the achievement of stability: we need to ask ourselves how best this is to be brought about.

The advantages of giving the Bank of England greater independence in the operation of monetary policy have been widely discussed by those who wish to see a long-term improvement in Britain's inflationary performance. I recognise, along with the Prime Minister, that any change to the current status of the Bank of England could pose a dilemma in the United Kingdom with our long tradition of parliamentary accountability on the floor of the House by a Minister of the Crown. I think all of us—politicians, academics, ourselves in the City—will need to consider how this dilemma might be reconciled. Put simply, it is how to devise a form of accountability that might enable us to have the advantages of a more autonomous central bank within the constitutional arrangements of our parliamentary democracy.