Sustaining the recovery

*The **Governor** discusses*[1] *the contribution that the successful conduct of monetary policy can make to sustaining economic growth. He explains how policies aimed at achieving stability will also promote employment. And he outlines the reasons behind the decision to raise interest rates by $^{1}/_{2}$% to $5^{3}/_{4}$% on 12 September.*

I am very glad to be here this evening—for two reasons. The first is that my visit gives me the opportunity to learn at first hand about economic conditions in this part of the country. The Bank attaches great importance to its direct contacts with industry—through the involvement of industrialists on our Court of Directors, through senior executive visits around the country such as this one and through our network of industrial agents, including Robin Webster in Newcastle. The information that we gather in these ways plays a significant part when we come to formulate our monetary policy recommendations.

My second reason is that this dinner gives me the opportunity to explain to you the reasons for last week's interest rate rise. But before I come on to that, I should like to say a few words about the economy more broadly.

It should go without saying that what we are ultimately seeking to do through monetary policy is to promote the economic prosperity of this country—the growth of output and employment. That is our whole aim in life. The debate, as I have said many times before, is about the *means* to that end, not about the end in itself; and for that we need to try to understand the *nature* of the pressures we are facing.

As a starting-point, I should like to distinguish between longer-term, structural pressures on the one hand and shorter-term, conjunctural pressures—those associated with the business cycle, if you like—on the other.

You here in the North East know as much about structural pressures as anyone! You have for decades lived through the rise and fall of great companies and industries under the impact of changing demands, changing technologies and changing production techniques, driven on by increasingly global competition. You know what that means in terms of economic and social stress. Those same pressures have affected—and are now increasingly affecting—the whole of the industrial world, including many of the service industries as well as manufacturing.

I know it's cold comfort, but in the longer term we all stand to gain from these developments. The world as a whole, for example, is clearly better off as a result of cheaper and more effective satisfaction of consumer needs; and rising real incomes, say, in countries like China and India with their huge populations are not only good in themselves, but they necessarily generate increasing demand for goods and services from other countries. Innovation and competition within free and fair markets make for a powerful positive-sum game. But it involves a process in which production can readily move from one location to another in search of cost advantages or in response to changing patterns of demand. And that process is a potentially difficult one in the short and medium term for established producers and for the countries in which they operate.

To survive—let alone prosper—companies and industries exposed to the full force of competition need constantly to update and innovate, and to improve their productivity. This often itself involves new production techniques, employing a smaller and typically more highly skilled workforce. At the macroeconomic level, this can improve a country's potential growth rate; but it also poses the threat of increasing unemployment—structural unemployment—especially among the less highly skilled, unless other companies and industries can be created or expanded to provide new jobs.

The problem of structural unemployment represents an enormous challenge to economic management—especially in Europe. I have in fact been very encouraged by the evidence I have seen of economic regeneration here in the North East—you have had some notable successes in attracting new activities. And that is true of this country as a whole, at least by comparison with some of our European partners. But there is nevertheless even here a huge overhang of structural unemployment already, and the pressure of competition continues to grow.

Now there is, frankly, not a great deal that monetary policy can do directly—and I emphasise directly—to improve the problem of structural unemployment. But an unstable monetary regime can make it worse. The direct remedies for structural unemployment lie for the most part in improving the adaptability and flexibility of the economy—through microeconomic, supply-side actions, for example improved education and training (including retraining), the removal of unnecessary burdens and constraints on business activity, and in improvements in the working of the labour market.

Most of these questions are outside the Bank of England's particular area of competence—except in one respect: we do

(1) In a speech on 22 September to the CBI northern regional annual dinner.

certainly have a role to play in helping to ensure that the financial system, including the banking system, is effective in supporting the wider economy. In this area we have been, as you know, putting a particular effort recently into trying to improve the relationships between the banks and the small business community. And we are persisting in those efforts because we believe that small businesses make an important contribution to the flexibility of the economy and to the problem of structural unemployment.

But the Bank's *main* business—its mainstream monetary policy—is concerned with a quite different problem. Its role is to provide a stable macroeconomic environment—specifically, price stability—as the context within which people and businesses can plan for the medium and longer term. To do this, we use interest rates to try to ensure that monetary conditions remain stable. This in turn helps to ensure that the economy grows at a sustainable pace and helps to prevent the emergence of inflationary imbalances between aggregate demand and the capacity of the economy to meet that demand. In this sense, monetary policy is concerned with conjunctural problems—and with trying to moderate the swings in the business cycle.

Where we are starting from recession, with the economy operating somewhere below capacity—as was certainly the case in this country in 1991–92—then it is perfectly true that monetary policy can, consistently with its stability objective, encourage the economy to grow at above its trend rate for a time, bringing down *cyclical* unemployment without that rekindling inflationary pressures. In principle, this can continue up to the point at which the economy is operating at full capacity, at which point the expansion has to be slowed down to the trend rate if inflation is not to revive. But in practice of course we do not know within a wide margin what the trend rate is, or how to measure full capacity—so that we have to operate pragmatically, watching carefully for early signs of re-emerging inflation as evidence that we are approaching full capacity, at least in some sectors of the economy, and allowing time for capacity in those constrained sectors to improve. And we have to be ready to moderate the expansion gradually, well before we overshoot. I will return to this in a moment.

The relevant point for the time being is that even to this degree we are talking only about the *cyclical* component of unemployment. We are not talking here about its *structural* component, though of course I understand that if you are unemployed you are not much interested whether it is for a structural or cyclical reason.

To the extent that monetary policy is successful in achieving greater stability over the cycle, it can contribute *indirectly* to improving the supply capacity of the economy and reducing the level of structural unemployment. Productive capacity and the associated labour force are more likely to be made prematurely—and permanently—redundant in a boom-and-bust environment, during the downturn; and new investment is more likely to be encouraged in the longer term by the prospect of steadier and more sustained expansion. To this degree, monetary policy has a crucially important role to play. But it cannot, as is sometimes implied, be used to attack the problem of structural unemployment directly—pumping up demand without regard to the existing supply capacity of the economy. That would be a sure recipe for the re-creation of inflation and a further round of go-stop.

What we are trying to do then, through monetary policy, is to deliver stability in this broader sense through permanently low inflation—defined by the Government as 1%–4%, and within the lower part of that range by the end of the present parliament. That objective and the reasons for it are, I believe, now very widely understood and supported.

In large part, that public understanding and support reflects the still relatively recent, bitter experience of what happens if inflation and the business cycle *are* allowed to get out of hand. But public understanding has also been helped, I believe, by the greater openness with which monetary policy is now conducted—through our own *Inflation Report* and through the publication of the minutes of the Chancellor's monetary policy meetings. What these procedures have demonstrated—to the satisfaction of all but a few dyed-in-the-wool sceptics—is that monetary policy decisions are essentially technical economic decisions and not dominated by short-term political considerations. They have also shown just how difficult and uncertain those technical decisions are. This has contributed over the summer to as good a public debate about the appropriate stance of monetary policy as I can readily recall.

The fact is that the immediate conjunctural situation is now more favourable than it has been for a generation. Inflation during the past year—whether you are talking about producer input or output prices, unit labour costs or any one of a range of measures of retail prices—has been as low as most of us can remember. Activity on the other hand has gradually accelerated, with gross domestic product rising by $3\frac{3}{4}$% in the year to June (or 3% excluding North Sea oil). This is well above anyone's guess at the trend rate of growth, and unemployment has steadily declined. Meanwhile the expansion has become better balanced, with some slowing in the growth of consumer spending and a flat secondary housing market leaving room for stronger growth of investment and net exports.

Why then has there been so much discussion about interest rates, and why did we raise them last week? The reason—and this was clearly reflected in the serious public debate, which is what so much impressed me—is that we were not just looking at what was happening last month or this; we were looking at what needed to be done to hold on to this favourable economic conjuncture looking out over the next two years.

Now the plain truth is that nobody really knows—at least with any precision or great certainty. The people to steer clear of are those who tell you it is obvious what is going to happen and obvious what should be done.

There were indicators pointing to some, moderate deterioration in inflation further ahead, which meant that we could not be wholly confident of achieving the Government's objective of the lower half of the target range for inflation by the end of the parliament. The data I have already referred to suggested output was growing faster and from a higher base than we had previously thought. This brought us closer to the point at which the economy would begin to encounter capacity constraints; and there were signs—perhaps a bit more than straws in the wind—of lengthening delivery times and associated price increases in some of the intermediate goods sectors. There were also, among business survey respondents, stronger expectations of price increases; and they were faced with a rise in commodity prices earlier this year.

There were, of course—as there always are—pointers in the other direction. I have already mentioned the flat housing market and slower growth in consumer spending. The monetary indicators themselves, especially broad money growth and the growth of bank lending, remained subdued. And there is further fiscal tightening still to come from the 1993 Budgets.

It is not surprising that, in weighing up this conflicting evidence, different commentators should emphasise different elements in the overall picture and reach different conclusions. What was striking to me, though, was how many outside commentators were already arguing for a prophylactic move during the summer—far more than one would normally expect in this country at this stage of an expansion.

In the end, of course, the judgment was a matter of balancing risks and, for our part, the risks did not appear symmetrical. Especially in the light of past failures to control inflation, any suggestion that the authorities were prepared once again to take risks on that side was likely to bring forward price—and possibly pay—increases which would make the prophecy of inflation self-fulfilling. The risk, on the other hand, that an interest rate rise now would seriously stall the overall expansion seemed comparatively small. In fact, a degree of moderation at this stage seemed just as likely to encourage business confidence in the sustainability of the expansion, and encourage business investment, as to dampen them; though that, I accept, of course can be argued either way.

So it was not, as you see, an easy decision and it was not taken lightly or wantonly. That is why—with the decision effectively taken at the meeting on the Wednesday—it was decided, wholly reasonably in my view, that we should reflect before going ahead. The Chancellor confirmed the decision on the Friday and, with no particular reason to delay, the Bank implemented it straight away on Monday morning.

The precise timing came as a surprise to the financial markets. Many people had come to expect a tightening at some point, but they had mostly concluded from the most recent data—even before the Wednesday meeting—that we would not in fact move this month. And they were confirmed in that view when we gave no indication of an intention to move through our money-market operations on the Thursday and Friday. I can understand that some of them felt they had been misled. But with the best will in the world, the process of advice and debate cannot reasonably be tied to reaching a decision to a precise timetable; and the Bank cannot be expected either to telegraph the intention to move or to implement policy changes to a timetable set solely by market expectations.

We will of course be continuing to monitor the flow of data. But unless it all goes in one direction—which would be surprising—we may not be sure for some time whether last week's move was either necessary or sufficient. But I am as confident as I can be that, by acting to raise interest rates in a carefully-considered and quite deliberate way, without any of the customary prompts—no financial market crisis and no sequence of unfavourable indicators patiently explained away until the evidence became overwhelming—the Chancellor has given us the best chance of creating the conditions in which the economy can continue to prosper. And that is as much as one can hope for. There can be no guarantees.

It was too much to hope that the business community would actually welcome the move—though some came courageously close to that. But if, by acting sooner rather than later, we can keep the economy growing at a sustainable pace and avoid the need to bring it eventually to a grinding halt, I will still hope one day to persuade you that timely increases in interest rates are not a cause for gloom and despondency, but a natural part of a benign process of stabilisation. I recognise that it may take us a little time!