The prospects for monetary stability

*The **Governor** picks out(1) a number of encouraging signs, both domestic and international, for UK economic prospects—including the monetary policy framework now in place which, in his view, provides the best chance in 30 years of achieving price stability in the medium term. Underlining the need above all else to avoid another cycle of boom and bust, he notes that the testing time will be the moment—which may still be some way off—when interest rates need to be raised to moderate the pace of expansion. He expresses the hope that, when that point does come, it will be seen not as evidence of weakness, but as a considered response to the underlying strength of the economy.*

This is a very special year for the Bank and it is a very special occasion for me—my first Mansion House dinner as Governor.

I am, of course, singularly fortunate to be Governor during this tercentenary year. During the past fortnight alone, I have been privileged to participate in the World Foreign Exchange Congress, the World Gold Conference and the International Monetary Conference, as well as acting as host to over 120 of my fellow central bank governors and former governors from all parts of the world at a conference of our own. All these events were organised in London to celebrate not just the fact of the Bank's 300 years of existence. They celebrated too one of the Bank's distinctive characteristics through so much of its history—its participation in international monetary co-operation and its involvement with, and in, the international financial markets which have their natural home here in the City. I am grateful to so many of our friends, from both this country and overseas, who joined in these celebrations with us.

But, My Lord Mayor, this is a special occasion for a quite different reason. The British economy is in its third year of expansion. But not only that, over the past year the *rate* of growth has exceeded the rate of inflation. The latest figures show that industrial production has increased by $5^1/_2$%, and manufacturing output by over 3%, on 12 months ago. And GDP—on the latest data—is growing at a rate of $2^3/_4$%. Retail prices, on the other hand, on the official measure of underlying inflation have increased by only $2^1/_2$% over the past year, or by only $1^3/_4$% if the effect of indirect tax changes is excluded.

There have been only 12 years since the war in which the rate of growth has exceeded the rate of inflation in this way—and only four years since 1970. So this too is also something to celebrate—something that is of profound importance for the future prosperity of the country as a whole.

Of course, it is not enough. We can't be satisfied with this achievement in a single year. The challenge is to improve on this performance and sustain it year after year. The crucial importance of stability—price stability as a necessary condition for the sustained growth of output and employment—is a theme on which I have spoken repeatedly during my first year as Governor. And I make no apology for that. But I will spare you that sermon this evening. The fact is that we have now taken the first steps along the path of sustainable, non-inflationary growth. The task now is to keep going. And, if you won't find this shocking coming from a central banker, I believe that the prospects are encouraging. Let me give you four particular reasons why.

First, there is the improvement in the world economy, including the recovery now clearly visible in our major markets on the Continent. This—taken together with agreement at last on the Uruguay Round of trade negotiations—provides a more favourable international context for activity in this country than seemed possible a year ago.

Second, there is the improved supply-side flexibility of our own economy—in both the goods and services and the labour markets—following the deregulation and liberalisation that has characterised the past decade and more. Compared with many countries—in continental Europe certainly—this means that we are relatively well placed to face up to global competition. It has meant too that, despite the intense pressures on larger-scale businesses to improve productivity and reduce their labour force, unemployment has nevertheless declined more rapidly than would previously have been expected at this stage of expansion. Employment continues to depend importantly on smaller businesses and I know that many of you here this evening are committed to ensuring that small business is served effectively by finance.

Third, there is our prospective fiscal position. The action taken by the Government—and indeed by our present Chancellor—last year progressively to reduce the PSBR was never going to be popular, whatever form it took. But such action was crucially necessary. It was necessary to achieve

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

a proper balance between fiscal and monetary policy; it was necessary to achieve a proper balance between domestic and external demand; it was necessary to make room for private sector expenditure, and for a shift in the balance of private spending from consumption to investment, without which the expansion could not be sustained.

And finally there is the monetary policy framework—which, I believe, gives us a better chance of moving towards our goal of price stability in the medium term than at any stage in my professional lifetime. Since we came out of the ERM, a series of steps have been taken to make our objective unequivocally clear and the policy process almost totally transparent. The latest step—the Chancellor's recent decision to publish the minutes of our monthly monetary policy meetings—will in time do a great deal to improve public understanding of our shared commitment to continuing low inflation. Those minutes will provide a full account of our discussions. We in the Bank will be publicly accountable for our advice, as is the Chancellor for his decisions. I have no doubt that this public accountability will over time improve monetary policy-making. It may, though, spoil the fun for some of the pundits who will no longer need to speculate about possible disagreements between us. They, and their clients, will have the authentic story of our discussions only six weeks after the meetings. I think that they will be surprised by the extent of the common ground between us.

So, My Lord Mayor, we have a good deal going for us in this country. Most fundamentally, there is a broader and increasing understanding—among the population at large and across the political spectrum—that we must not this time allow the expansion to get out of hand, that we must above all else avoid the social and economic trauma of another cycle of boom and inevitable bust. That is a great strength.

I recognise that there are nevertheless still those who are yet to be convinced—both of the validity of the approach and of our determination to stick to it. They will judge only by performance.

The testing time will come—as it must inevitably come sooner or later—when we need to raise interest rates in order to moderate the pace of expansion and pre-empt the emergence of associated cost and price pressures. With the economy still operating below capacity—though no-one can know just how far below—it may be that this point is still some way off. But whenever it comes, I hope that it will be regarded positively, as a considered response to the underlying *strength* of the economy and to the prospects for inflation in the medium term, and not as evidence of *weakness*, in simple knee-jerk reaction to the latest set of erratic monetary or economic data. Our purpose will be to maintain the expansion at a sustainable pace, and not to leave the tightening of policy so late that the economy is brought to a juddering halt by a much larger interest rate rise than would otherwise be needed.

Successful monetary management cannot be judged—as some seem tempted to judge—by how low interest rates can be pushed or by how long they can be held down. Nor is it a matter of snatching at what casual observers may see as 'windows of opportunity'. That lies at the root of short-termism in both finance and industry. Monetary policy has to be judged by its success in achieving and maintaining the price stability that will allow the growth of output and employment to continue.

The prospects today are, as I say, encouraging—provided we stick to our course. It is a realistic hope that next year I will be able to report to your successor on a second consecutive year of growth above the rate of inflation—and I even venture to look forward to the year after next!

In the meantime, My Lord Mayor, let me congratulate you and the Lady Mayoress on your extraordinarily active and successful period in your high and historic office. You have made the international promotion of the City financial the theme of your Mayoralty, and I pay warm tribute to all that you have achieved. The whole City is delighted that those achievements have been recognised through the knighthood conferred on you in Her Majesty's recent birthday honours.