Monetary policy realities

*The **Governor** explains[1] the background to—and the limited extent of—his disagreement with the Chancellor earlier in the year. This was neither about the aim of monetary policy—preserving the best prospect of sustained expansion for decades—nor about the means of achieving it: by maintaining permanently low inflation. It was a narrow difference of judgment about the need for a further rise in interest rates in order to achieve the inflation target, in a situation in which that judgment was particularly difficult. He underlines the need to distinguish this narrow difference of judgment from the seductive—and dangerous—position of some critics, who want monetary policy to be used to boost activity in the short term and are prepared to take bigger risks with inflation.*

It has been a long, hot summer for the Bank of England—though at least we avoided the drought. In fact, we have been in hot water most of the time. To judge from the media, we have been engaged in various forms of sporting contest with the Chancellor of the Exchequer. Each economic statistic, each twitch of the financial markets has been reported as if it were a crucial point in some sort of timeless tennis match:

Chancellor to serve

- weak domestic demand
- softer commodity prices
- steady earnings growth
- slower fall in unemployment
- slow rise in retail price inflation and falling retail sales

Bank returns

- rising exports
- increasing producer prices
- rising unit wage costs
- faster rise in money supply

Game and first set to the Chancellor!

Now, all of this is no doubt good, clean fun. As a matter of fact, I quite enjoy playing tennis. But there really is rather more to it than that.

What we in the Bank think we have been doing—and not just during the summer—is not *playing against* the Chancellor, but *working with* him to try to preserve the best prospect of sustained expansion that this country has had for decades. That is what the Chancellor thinks we have been doing too.

There is no difference whatsoever between us, either, on how to go about it. What we are both aiming to do is to put the British economy on to a permanent basis of low inflation. And we are not doing this for its own sake; we are doing it because permanently low inflation—a situation in which people can confidently rely upon the value of money—is the best contribution that monetary policy can make towards encouraging rational, long-term economic decision-making in this country and towards promoting the sustained growth of output and employment over the medium and longer term. I will come back to that.

This is why, in 1992, the Government adopted an explicit target for retail price inflation (measured after excluding the effect of changes in mortgage interest rates). And this is why the Chancellor decided in June this year to extend the inflation target into the indefinite future, with the intention that monetary policy should be consistently directed to achieving an inflation rate (as defined) of $2^1/_2$% or less.

Under our present monetary arrangements, the Bank is required by the Chancellor to make—and to publish—an independent, quarterly assessment of the likely course of inflation over the next eighteen months to two years; and this we do in our *Inflation Report*. We are also required to advise the Chancellor, at our monthly meetings, on the monetary policy that we judge to be necessary to achieve the Government's inflation target over the same eighteen months' to two years' time horizon. The minutes of these monthly meetings are—as you may be aware—also published, so that everyone knows precisely what advice we give and what our reasons are for that advice.

The Chancellor must make his own assessment about the inflation prospect—which, of course, may differ from our own, and he has every right either to accept or reject our advice in reaching his decision. That decision is also explained in the minutes. We recognised from the outset that this unique transparency of the policy process would not be particularly comfortable for either of us; but it would surely concentrate the mind and, we hoped, improve the quality of the public debate. It has certainly achieved the first of these objectives—and, to be fair, also I think the second.

(1) In a speech to the North West Chamber of Commerce in Manchester on 18 September.

Beginning last autumn, we agreed that, if we were to have a reasonable chance of achieving the inflation target, monetary policy needed to be tightened. Interest rates were raised by 1½%, in three ½% steps, to their current level of 6¾% by February of this year. That tightening of policy was intentionally pre-emptive, in the sense that it came earlier in the expansion than it would have done typically in the past, and before the upward movement of retail prices became apparent in the statistics. By moving to tighten policy sooner rather than later in the expansion, we aimed to avoid the more violent, and ultimately larger, increases in interest rates—often made under the pressure of emerging crisis in the financial markets—that we have experienced so often before. And it is encouraging that after we started to tighten, expectations about future interest rates, reflected in the financial markets, in fact fell—from an expected peak of over 9½% in September last year to around 8½% by early May.

I have characterised this approach to policy elsewhere as 'a stitch in time to save nine'. I might perhaps have said 'to save eight'.

By May, our judgment remained that we were still more likely than not to exceed the inflation target, and that policy would accordingly need to be tightened somewhat further. The Chancellor—as is his right—took a somewhat more optimistic view of the inflation prospect and decided that interest rates should remain as they were and where they have stayed ever since, at 6¾%.

Now I would make two comments on this episode. The first is that there can be no certainty in any of this. Monetary policy operates with a time lag of some two years or so, so that in pursuing the inflation target we have to operate on the basis of what we expect inflation to be that far ahead. And what we are talking about the whole time is a balance of probabilities and a balance of risks. The people to beware of are those who claim to *know* what the outcome will be. The devil of it is that it can be many months before the prospect—or the effect of monetary policy decisions—becomes any clearer, and by then of course it may well be too late. The position is rarely black and white at the point where decisions have to be made, but varying shades of grey; and in this situation the real issue is not whether any particular decision is right or wrong: it is whether the outcome is better or worse on balance over time.

My second comment is that in these circumstances, the disagreement about the inflationary outlook—in and since May—has been well within the reasonable range of uncertainty. We have argued that it is more probable than not that inflation will turn out to be above the target 2½%, but we have not argued that inflation is likely to accelerate dramatically. And the Chancellor agreed that the decision was finely balanced.

In fact, the situation that confronts us is particularly difficult to judge at present—for two main reasons.

On the one hand, the immediate inflationary pressure has been coming essentially from higher input costs—largely associated with the rise in the prices of imported raw materials and semi-manufactures last year, aggravated by a fall in sterling's exchange rate in the spring. It has not been driven by excess demand in this country.

On the other hand, we are breaking new ground in terms of the domestic economy. We have no real previous experience of the economic effects of adjusting to permanently low inflation, particularly on the behaviour of the household sector; and we have little experience either of a 'dual' economy, with such a great divergence between some sectors which are stretched to capacity while others remain in the doldrums. Let me expand briefly on these two points.

Manufacturing input costs—especially the cost of imported raw materials and semi-manufactures—began rising quite sharply from the beginning of last year. Although the rate of increase apparently moderated during this summer, the cumulative rise in input costs up to last month was some 15%. This input cost pressure was initially offset by falling unit labour costs, resulting from rapid growth in manufacturing productivity. But over the past year, productivity has grown much less, so that labour costs rose almost as fast as average earnings in manufacturing—by just over 4% in the year to July. (This was at a time, incidentally, when unit labour costs in most of our main competitors were falling.)

Despite strong resistance at subsequent stages of the production/distribution chain, these cost pressures have increasingly passed through into manufacturing output prices and into retail prices. Output prices rose by some 4½% in the twelve months to August (compared with 2% a year earlier), and retail prices (on the target measure—RPIX) rose by 2.9% in the latest twelve months to August (compared with 2.3% a year earlier). (Again, incidentally, retail prices are rising faster in the United Kingdom than any other G7 country, except Italy.)

Now there are a number of caveats one might make about all this, but what it suggests is that there are still significant cost pressures in the pipeline (running from material and labour input costs to retail prices) that have either to be absorbed in profit margins or passed on in price increases. This is true notwithstanding the fact that some of those pressures may have started to abate at the earlier stages of the production/distribution chain.

Now these cost pressures are difficult to contain directly through monetary policy. In themselves, even if they *are* passed on, that would in principle result in a one-off higher level of retail prices but not necessarily a longer-term higher continuing rate of retail price inflation. But cost pressures cannot simply be ignored. The risk is that the initial price rise will trigger a rise in domestic costs—through higher wage demands, particularly—that *would* have a more lasting impact on the rate of inflation.

How far these pipeline cost pressures are in fact absorbed, and how far and how fast they are passed on, and to what extent that has knock-on effects on domestic costs, depends in the short term on the pressure of demand in the real economy, and in the longer term on the extent to which price pressures are accommodated by monetary policy.

Here, there is no dispute that the rate of growth of demand and output has slowed over the past year. Non-oil GDP growth had accelerated to an annual rate of over 4% in the summer of 1994, but slowed to a more sustainable rate of some 2½% in the first half of this year. The extent of the slowdown, which became more apparent as we went through the summer, was a little more than we would have expected, but not significantly more. What was more surprising, as the data emerged through the summer, was the *pattern* of demand. Earlier, domestic expenditure—particularly by the household sector—had been growing only modestly, but this was compensated by strong growth in net exports, so that while there was clearly spare capacity in the domestically oriented sectors of the economy, the export-oriented sectors became quite fully stretched. But in the first half of this year—taking the first two quarters together, to remove erratic variations between them—there was a marked decline in the rate of growth of final demand both domestically and through a smaller improvement in the balance on net external trade, partly offset by a sizable build-up of stocks.

The slowdown in net export demand growth we attribute largely to a pause overseas—associated with a mild stock cycle in the United States and continental Europe. The likelihood is that this will correct itself quite soon, though we cannot of course be sure. The build-up of stocks domestically, which appears in part to have been unplanned, suggests that we may go through—indeed may be going through—a similar stock adjustment in this country. But that too we would expect to be relatively short-lived. Meanwhile we would expect the growth of final domestic demand gradually to pick up. But again, of course, we cannot be sure.

In the meantime, underlying monetary growth remains quite strong. Broad money growth in particular has accelerated since the spring, to a three-month annualised rate of growth of some 10%, while credit has been growing at an annual rate of 8%–9% since the beginning of the year. This would be consistent with increasing demand and activity—though the monetary data are always difficult to interpret over comparatively short periods.

Now, I have gone over all of this—in more detail than you might perhaps have bargained for—to try to explain to you just how uncertain the process is. We have never pretended otherwise. In coming to a judgment, we have to take account of all the information available to us at the time, and of course then modify that judgment to take account of new information as it becomes available. In May, our judgment was that we were substantially more likely to exceed the inflation target without some further rise in interest rates than we were to achieve it. That judgment was wholly justified at the time, and was indeed shared by the great majority of commentators. In the light of all the information that has become available during the summer—and, in particular, of the information on the pattern of demand—we have, of course, modified our judgment.

We now think that there is a somewhat greater chance that output growth will continue for a time to be weaker than we would have expected in May. This means that we see a somewhat better chance of achieving the inflation target over the next 18 months or so. We agree therefore that the case for an immediate rise in rates has become progressively less pressing, and we are not in fact pressing for one—and have not been doing so since before the summer break.

Nevertheless, we still think the chances are *against* achieving the inflation target over the next 18 months or so without some further rise, and both the financial markets and a majority of outside forecasts still appear to share that view. The markets are implying an inflation rate of about 4% in two years' time, rising subsequently to some 4½%. And of the 40 or so outside forecasts that we monitor, only five expect that retail price inflation (RPIX) will be below 2½% by the end of next year, and some of them assume higher interest rates in the meantime. Looking on the bright side, only three expect inflation then to be above 4%.

You are probably wondering at this point, 'If that's the extent of the difference, what's all the fuss about?' Well, I have been wondering that too! Given the degree of uncertainty, the difference between the Bank and the Chancellor is a narrow difference of judgment about the balance of risks. No-one will be more delighted than I will be if we do in fact hit the inflation target without some further rise in interest rates. I will happily then eat humble pie—I am told anyway that it is good for the digestion. But I will wash it down with champagne—because it would be the best possible news for the long-term health of the British economy.

But I am afraid that much of the fuss is not in fact about this narrow difference of judgment, it is about something more fundamental. Many of our critics are not actually saying they think our analysis is wrong and that we are in fact odds on to achieve the inflation target—or, if they are, they are keeping quiet about it. Many of them are really saying that we should not worry so much about the inflation target. They imply that the softening of the real economy and the slowdown in the fall in unemployment, in themselves, are enough to justify keeping interest rates unchanged—or even, now, reducing them—even if that means we do not hit the inflation target. They want monetary policy to be used to boost output and employment directly in the short term, rather than being consistently directed to the achievement of low inflation which, as I said at the outset, is the fundamental purpose of the inflation target.

This, I have to tell you, would be to turn the clock back to precisely the approach that lay at the heart of the boom and

bust which caused so much social, as well as economic, distress in the past and from which we now have a real opportunity to escape.

In its most seductive form, the argument runs that there is still a good deal of slack in the economy and, in that case, if the price of getting inflation down to $2^1/_2$% or less is higher interest rates and slower growth now, then it is not worth paying. Let's take a chance on having 'just a bit' more inflation: it might even do us some good. I have also heard the argument put in less seductive terms—that we should deliberately aim for a bit more inflation because it would certainly make us feel good.

Well, Mr Chairman, we have been there before. The trouble with this approach—even in its seductive form—is that we do not actually know how to achieve 'just a bit' more inflation. Inflation is a dynamic process. You may for a time be able to get away with 'just a bit' more inflation in a country with a history of stability. But, given this country's track record, once you have signalled greater tolerance of inflation in the interests of sustaining activity, it is perfectly rational for people who can—producers in their pricing policies, employees in their wage claims and so on—to pitch in and grab what they can while the going is good. Inflation then accelerates, and at some point it *has* to be brought back under control. And at that point, the tightening of policy will almost certainly need to be more disruptive, and interest rates pushed higher, than would be necessary if inflation had been kept under control in the first place.

I realise, of course, that these questions are partly matters of degree. I would understand the (seductive) case for effectively relaxing the inflation target much better if, in order to achieve it, we were expecting to have to raise interest rates very substantially and to plunge the economy into recession. But that is not—as I explained in the earlier part of my lecture—the situation we believe we are in.

We are not, as I say, now pressing for an immediate interest rate rise—though some further rise may still be necessary. Nor are we expecting to fall back into recession, although we cannot rule out some further temporary slowdown in the rate of growth; and if there were clear signs that final demand was weakening substantially, that in itself would be likely to affect our view about the inflation prospect and that too would then naturally feed into our policy advice. The Bank has no interest in having interest rates even $^1/_4$% higher than they need to be to make it probable that we will achieve the inflation target. Our aim, in fact, is to keep interest rates below what they would otherwise be in anything other than the short term.

Mr Chairman, there is a lot going fundamentally right for the British economy. We are now into our fourth consecutive year of expansion and the likelihood is that that expansion will continue fairly steadily over the next couple of years—and that is as far ahead as one can realistically hope to see. That expansion is likely to be driven importantly by net exports and investment, particularly manufacturing investment in plant and machinery, and that should help to make it more robust.

Of course, there are uncertainties and, even on this scenario, there is a very long way to go. I understand the current concerns—the patchiness of the economy, with important sectors still struggling, having so far been hardly touched by the expansion. I understand the wider fears of a more general slowdown in output and employment growth, and I understand the temptation to look for more stimulus in the short term. But if that means, as it always has in the past, taking a risk on 'just a little bit more' inflation, then it would be extraordinarily short-sighted, putting at risk the best opportunity for sustained expansion that we have had for decades. I doubt whether that would do any of us very much good—even in the short run.

That is not the issue between the Chancellor and the Bank—which is on a much narrower point. We are, I repeat, working together to preserve the favourable medium-term prospect for the economy. The Bank will continue to direct its advice to that end. And that is what the Chancellor would expect—indeed requires—us to do.