Economic growth and employment through stability

*The **Governor** argues[1] that at present there is a remarkable consensus on what macroeconomic policy can be expected to achieve, namely stability. But the really interesting questions are about what policies can best achieve stability. The task is complicated by imperfect information and because economies are subject to various kinds of economic shock. The **Governor** argues that we cannot aspire to continuous stability because we do not have sufficiently reliable information on the rate of change in the supply-side capacity of the economy, or sufficient control over aggregate demand in the short term, and there is the ever present possibility of shocks. The question then is, given these uncertainties, which macroeconomic variable is it most sensible to target? The **Governor** considers three broad choices—nominal external anchors, real domestic targets and nominal domestic anchors—and summarises the United Kingdom's experience with the last, namely an explicit inflation target.*

The subject I have chosen for my lecture is 'Economic growth and employment through stability', and what I will try to do is to explain just what it is that we are trying to do through monetary policy—essentially short-term interest rate policy—at the Bank of England and why.

The objective of stability

To begin at the beginning—the very beginning, I take it as common ground that the fundamental objective of economic policy in this country is to promote the economic welfare of our people through the growth of economic activity, high levels of employment, and rising living standards within the United Kingdom as a whole. I say in the United Kingdom because I am talking about our national policy objectives, but of course I agree that those objectives can be pursued more successfully in the context of a flourishing, open, world economy, which we can help to promote through international policy co-operation—in the IMF and IBRD and WTO, for example, and within the European Union. All that I take as given.

But to say that we are aiming to promote economic welfare is simply to state an objective. The really interesting questions—for economists and other commentators, and for policy-makers alike—are about how best that objective can be achieved. And it is the debate about the means rather than the end which has over the years generated so much heat and just occasionally some light.

A leading article in *The Independent* newspaper recently began by asking 'Where is Keynes? Where is Friedman? Economics once debated the very future of the nation: how it should be governed, how it could generate growth'. The article went on to describe the present state of the debate about macroeconomic policy as 'deadly dull, embraced in a suffocating classical consensus' which is subsequently defined to include the control of inflation and fiscal prudence, as well as free trade and market competition. Macroeconomics has become less controversial, the article suggests, in part because we recognise that some problems, for example, unemployment, are treatable only in the long term. The real debates now, it says, are about microeconomic issues—training policies, gas prices and education strategies, for example.

I must say it makes a change to be associated with spreading suffocating dullness. But I agree with the underlying point that there is, internationally and not just in this country, a remarkable consensus on just what macroeconomic policy can be expected to achieve, which can be summed up in one word—stability. On this view, the long-term objectives of raising the underlying growth rate and increasing employment need to be addressed through more fundamental, structural, policies.

Now it would be wrong to suggest that the present consensus is radically new. In fact, Keynes—referring to my illustrious predecessor, Montagu Norman—noted in 1923 that:

'All of us, from the Governor of the Bank of England downwards, are primarily interested in the stability of prices, business and employment'.

You might equally have made the same remark in your introduction this afternoon, Vice Chancellor. What stands out is that Keynes clearly regarded these objectives as mutually compatible. And Milton Friedman, too, was not interested in the money supply simply as an end in itself but as a means to the end of stability in the broader sense of prices, output and employment—which is the objective of today's macroeconomic orthodoxy.

Let me try to explain why by illustrating the effects of macroeconomic instability—and the uncertainty associated

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with it—on real economic decision-making. I take two every day examples.

First, think of a firm contemplating an investment project which is to be financed by a bank loan. In deciding whether to undertake the project, the firm tries to calculate future profit streams from the investment, after allowing for debt repayments, on a suitably discounted basis—it makes a present value calculation. Now in the textbooks that all seems fairly straightforward. But instability in prices or in activity—or indeed in interest rates or exchange rates—makes these calculations a real nightmare. Forecasting future cash flows from sales becomes a lottery; so too does assessing the likely real cost of servicing the debt.

Faced with such uncertainties a firm would rationally respond by demanding a higher expected rate of return on its investment as compensation for the risk. And the greater the uncertainty, the larger the risk premium, and the more it foreshortens firms' planning horizons because of the higher discount they need to apply to more distant projected profit streams.

Similarly, the greater the uncertainty about inflation, the harder it is for businesses of all kinds to distinguish between real and nominal returns. A year or more ago a Bank survey found that companies were still looking for nominal returns on investment of 20% or more as they had been for some years, even though inflation had fallen in the meantime from over 10% to less than 3%. When I suggested that such target rates of return were only appropriate when we had 'funny money' but not now that we had 'real' money, and that they were missing out on attractive investment opportunities, they told me that was all very well in theory but they would begin to believe it when we had shown that inflation would *stay* below 3%.

So the result of uncertainty, very simply, is that 'good' investment projects—projects which could have been profitably undertaken in a more stable economic environment—end up being rejected. Both business and financial investors become preoccupied with short-term returns, and it is easy to see how long-term economic growth suffers as a consequence. Macroeconomic uncertainty is in this respect a far more persuasive explanation, in my view, of the short-termism that has inhibited our investment performance than the particular characteristics of our financial system.

My second example of the effects of instability and uncertainty on everyday decision-making concerns the problems faced by households contemplating investment decisions—for example when considering whether to buy a house financed by a mortgage. Here, too, there is depressing scope for decisions to be made which are subsequently undermined by events—for example when households are unwittingly sucked in to a bubble in property prices that inevitably then bursts. The 350,000 home owners whose properties have been repossessed during the 1990s would, I think, vouch for the devastating consequences.

These two examples, of firms and households, well illustrate the distortions in every day investment decision-making that are rooted in the general instability of prices and activity. And, even though our economy has now been relatively stable over the past few years, uncertainty as to whether that stability will continue is still very much with us.

Stability of what?

I hope that I have said enough to explain why macroeconomic stability in its broadest sense is judged to be so important to the promotion of rational economic decision-making and, through that, to the promotion of economic welfare. The more difficult question remains, how we can achieve macroeconomic stability?

Essentially what it involves is trying to ensure that aggregate demand in the economy does not get too far out of line, in either direction, with the capacity of the economy to meet that demand over the medium and longer term.

Now of course that's much easier said than done.

The capacity of the economy to supply goods and services at any particular time—the economy's 'productive potential'—is determined by its structural features, for example by the size, and the level of training and skills, of the workforce, by the size and productive efficiency of the capital stock, the degree of labour and capital market efficiency, and so on. And the rate at which productive potential grows depends largely on the changes affecting these factors—demographics and the effectiveness of the education system, for example, or on the rate of investment and the extent to which technological progress is being absorbed into new products and techniques, or on microeconomic changes in market flexibility. These *supply-side* factors are, in the main, beyond the reach of *monetary* policy. We can, however, help indirectly, if we are successful in providing a stable macroeconomic backdrop against which more rational and efficient, longer-term, decisions can be made. In this way monetary policy can contribute indirectly to improving the supply side of the economy in much the same way as, for example, better training and education. And, monetary policy aside, the Bank of England can help, too, by encouraging the financial sector to provide more effective support to the wider economy—as we have, for example, by encouraging lenders to provide a wider range of facilities to small businesses.

But, for the most part the immediate role of monetary policy is to influence the *demand* side of the economy, seeking to maintain macroeconomic stability by keeping aggregate demand in line with productive potential as it evolves over the medium and longer term.

The task is complicated not just by imperfect information and knowledge and by the time it takes for policy changes to have their full effects, but also because the economy is

subject to various kinds of economic 'shock'. Such shocks may originate either at home or abroad, and they may affect either the demand or supply side of the economy. Examples include a change in world oil or other commodity prices, conjunctural or structural developments in overseas markets, or changes in domestic consumer or labour market behaviour.

Policy cannot necessarily reverse the effects of these shocks. But it can try to offset them so that they do not set in train a continuing destabilising effect on the domestic economy. Monetary policy was, for example, powerless to reverse the initial effects on import prices of sterling's depreciation following our exit from the Exchange Rate Mechanism in 1992. But, alongside fiscal policy, it did help to ensure that this shock did not have second-round effects leading to a general inflationary upsurge. Similarly we used monetary policy to head off possible second-round effects following the rise in world commodity prices in 1994 and sterling's further depreciation in the spring of 1995.

Now clearly in an ideal world we might conceivably hope to keep demand continuously exactly in line with the supply capacity of the economy. That would, in principle, ensure price stability, steady growth at the underlying sustainable or trend rate, a broadly stable level of employment at its 'natural' or non-accelerating inflation rate (NAIRU), and a reasonably stable exchange rate against the currencies of other countries successfully pursuing similar polices. Even in this ideal world we could not expect stable short-term interest rates, because they are the instrument we would still need to use to keep demand and supply in balance and to offset shocks; but to the extent that we were successful in maintaining stability over time interest rates—both short-term *and* long-term interest rate—would typically be lower, and fluctuate less, than we have been used to because they would include a smaller uncertainty or risk premium.

We frankly cannot aspire to *continuous* stability in the real world. We do not have sufficiently reliable information on the rate of change in the supply capacity of the economy; we do not have sufficient control over aggregate demand in the short term; and there is always, as I say, the possibility of economic shocks of greater or lesser degree. So in the real world you may have to choose to seek to stabilise one dimension of the macroeconomy at the expense, at least in the short term, of others.

The danger in this situation is that if you try to juggle too many balls at once in this way you end up with them all on the floor. The Dutch economist, Jan Tinbergen, first established the principle that policy-makers can, in effect, only successfully juggle as many balls as they have free hands. For much of the time after the war this principle was neglected in operating macroeconomic policy. Fiscal *and* monetary policy, supported for much of the time by various forms of direct controls, were jointly applied to juggling objectives which were seen to be in conflict in the short term—including growth and employment, on the one hand, and price stability and balance of payments equilibrium, as well as a fixed nominal exchange rate, on the other. In practice, policy as a whole was directed to expansion, until the inevitable imbalances become critical, at which point policy shifted abruptly to restraint—in a go/stop policy cycle, which contributed to the notorious boom and bust economic cycle. And the cycle tended to become more unstable as people learned to take advantage of the upswing while the going was good, before the rain came. In trying to be a jack of all trades, policy ended up the master of none.

Progressively over the past 20 years or so, it came to be recognised that there is in fact no trade-off—except in the short term—between growth and stability, and the emphasis of macroeconomic policy has shifted to maintaining stability in the medium to longer term. But the question remained—stability of what? While the ultimate objective clearly is to achieve long-term stability in the broad macroeconomic sense I have described, given that the different dimensions of stability can diverge in the short term, which particular macroeconomic variable is it most sensible to target?

There were—and are—in effect three broad choices: a nominal external anchor, typically the exchange rate against another currency or group of currencies that were themselves expected to reflect stability-oriented policies; a real domestic target, such as employment or output; or a nominal domestic anchor such as the money supply, nominal income or inflation. The issue is which of these various regimes offers the best prospect of long-term macroeconomic stability in the broader sense—or which minimises the risks of macroeconomic *in*stability.

An exchange rate target

The United Kingdom has had long—if intermittent—experience of an exchange rate target in one form or another, from the international Gold Standard, through Bretton Woods to the European exchange rate mechanism. In each case the regime eventually foundered. And the principal cause was an asymmetric shock affecting the anchor currency—the dollar under Bretton Woods in the context of the Vietnam War, for example, or the Deutsche Mark within the ERM in the wake of Germany's reunification.

In the face of such asymmetric (country specific) shocks, which could affect either partner country, the *external* demands of policy need no longer be consistent with *internal* stability of prices and activity. Tying yourself to the mast can, even for quite long periods in the right circumstances, pay dividends. But if you are tied so tightly that the blood circulation becomes cut off in a storm then it can become self-defeating.

This was precisely the United Kingdom's experience within the ERM. In the end Germany's legitimate domestic policy needs following the economic shock of reunification diverged from the domestic stability needs of the British

economy (and those of much of the rest of Europe). And if the external need to maintain sterling's parity against the Deutsche Mark had continued to take precedence, then monetary policy would have itself become a source of greater domestic instability in the form of loss of output and employment. It is true that in principle this dilemma can be avoided by timely exchange rate adjustment—but in practice this is extraordinarily difficult to achieve. And it was particularly difficult to achieve in the wake of German reunification which, analytically, required a real exchange rate appreciation of the Deutsche Mark against other currencies as a whole, in order to support the reconstruction of East Germany, rather than the depreciation of particular ERM partner currencies—although, for quite separate reasons, there may in some cases have been a need for that as well.

In fact there is an intrinsic potential Catch 22 situation in relation to exchange rate arrangements of this sort. The intention is that the commitment to *nominal* exchange rate stability between the partner currencies should serve as an external discipline on domestic policies. But nominal exchange rate stability cannot in itself ensure *real* exchange rate stability; nor can it accommodate asymmetric shocks, like German reunification, which require a real exchange rate adjustment. Because it is real exchange rates that affect domestic activity, such arrangements are necessarily vulnerable to domestic/external policy dilemmas. The Catch 22 is that the easier it is made to change a parity in a 'timely' way (or the wider the permitted margin of fluctuation around the parity) the less effective the exchange rate regime is as an external discipline on domestic policy; whereas the tighter the exchange rate regime the more vulnerable it is to policy dilemmas of this sort and to associated exchange market disturbance.

These considerations would apply to any successor to the ERM seeking to link non-participating EU currencies to the euro just as much as they have applied to the ERM hitherto.

There are related risks in relation to monetary union and the single currency itself, although the potential tensions would manifest themselves in a different form. The risk is that macroeconomic imbalances become locked in—either because of inadequate economic convergence between the participating currencies at the outset or because of significant asymmetric shocks affecting particular participating countries after the single currency has come into being. The danger is that the intended 'zone of stability' might then become a source of *in*stability, resulting in tensions of various kinds—ranging from long-term stagnation in parts of the euro area, or unwelcome migration in search of work or pressures for larger intra-area budgetary transfers or pressures for protection against either inside or outside competition. These risks were recognised in the Maastricht Treaty itself; and the convergence criteria, as well as the emphasis attached to the sustainability of convergence, were introduced precisely in order to minimise them. It remains the case that how serious the risks are depends crucially on the criteria not only being rigorously applied in substance at the outset, but also being realistically expected to be sustained over the longer term.

Experience with exchange rate targets has been mixed. There is no doubt that they have served as a useful policy discipline for many countries, particularly smaller countries, helping them to achieve relative domestic policy discipline. And they have functioned perfectly well, without great tensions, for quite long periods of time. But they necessarily involve risks—as we have seen in practice in other cases—risks that can be largely avoided by arrangements that put the emphasis on the domestic stability horse rather than the nominal exchange rate cart. The point is not that exchange rate stability is unimportant. It is that you can achieve reasonable exchange rate stability between the currencies of countries pursuing domestic stability with less risk. You certainly will not achieve it for long without domestic stability in the partner countries.

A real domestic target

An alternative policy regime that *does* place the emphasis on domestic stability might be for macroeconomic policy to target output growth around its trend rate, or, roughly equivalently, unemployment around its so called 'natural' or non-accelerating inflation rate (NAIRU). Let me be quite clear. I am not talking about targeting an arbitrarily chosen growth rate or an arbitrarily chosen rate of unemployment—based simply upon political aspiration. However desirable faster growth and lower unemployment are, such an approach to achieving them would be an absolute recipe for instability. As I explained a moment ago the sustainable rate of growth or the natural rate of unemployment depend upon structural features of the economy, and while it is reasonable—and very desirable—that we should aspire to raise the sustainable growth rate, or lower the natural rate of unemployment, over time by structural policies, if you tried to do the same thing simply by macroeconomic, demand management—simply pumping up demand—it would lead directly to accelerating inflation. What we are talking about here, in the context of a possible macroeconomic objective, is targeting the *trend* rate of growth or the *natural* rate of unemployment, whatever they are at any particular time, *given* the structural characteristics of the economy.

On this basis such a scheme has considerable conceptual attraction—the essence of monetary policy is after all, as I said earlier in my lecture, to maintain equilibrium between demand and supply, and this would seem an obvious way of seeking to do that. The trouble with this approach is that in practice we do not know at any particular time, within a wide margin, what the appropriate numbers are. There are just about as many guesstimates as to the magnitudes as there are economists! Present estimates of the 'output gap', ie the extent to which we are currently below trend in terms of output, range from virtually nothing to 5% or even 6%. And estimates of the natural rate of unemployment range from around the present level of recorded unemployment (just below 8%) to 4% or even 3%.

So you can see that depending on the numbers that you choose the appropriate monetary policy stance would be wildly different. This makes such concepts as the 'output gap' or the 'trend rate of growth' or 'the natural rate of unemployment' or NAIRU dangerous to use directly as a practical guide to policy, however helpful they are in thinking about policy.

A nominal domestic target

This then leaves the third policy framework option—which again places the emphasis on domestic stability—a *nominal* domestic target. These come in various guises, but the three most widely advocated are targets for measures of the money supply, for nominal income, and for inflation. The differences between these three regimes are really more technical than philosophical. All of them in the medium to long run ought to be capable of delivering a high degree of nominal stability, which should equally result in substantial real economic stability. But they raise different issues and difficulties that need to be considered in making the choice between them.

Let me take *monetary targets* first. These are intermediate targets in the sense that the assumption underlying them is that there is normally a broadly stable, or at least predictable, medium to long-term relationship between the money supply on the one hand and nominal income on the other—in other words, to use the jargon, that money velocity is relatively stable. This has, in fact, proved to be a reasonably reliable approach to policy, for example, in countries like Germany, although even there it requires a good deal of creative interpretation. But in a number of other countries, including this country, that has not been the case. Money velocity has varied unpredictably as a result particularly of continuing financial innovation and changes in the pattern of financial intermediation, so that, even with the most careful interpretation of the monetary data, money supply targets have not in practice been a reliable guide to developments in the economy. In fact our experience in the early 1980s was that failure to achieve our monetary targets damaged the credibility of monetary policy even though we were reasonably successful at that time in achieving the end objectives of policy. While, therefore, we continue to monitor monetary developments very carefully, alongside all the other available evidence, for what insights they can give us, and while we retain guidelines for the growth of both narrow and broad measures of money, we no longer use monetary targets as the primary guide to policy to the extent that we did.

Where the relationship between the monetary aggregates and nominal income *is* reasonably robust, and where the relationship operates with a lag, monetary targets have in principle a considerable advantage in that the money supply, for which firm data become available quite quickly, acts as a *leading* indicator for policy. In practice, of course, the process is never automatic and the policy message even under this regime is looked at in the context of forecasts which bring in other information. Other nominal domestic regimes—for nominal income and inflation targets—are, as a matter of degree, more heavily dependent in their operation on macroeconomic forecasts.

As between these alternatives, there is perhaps not any very fundamental difference operationally. But inflation is more readily understood by the public at large and likely, therefore, to have more impact on expectations and behaviour. Moreover, *a nominal income target* would need to incorporate a view about the trend rate of growth, which means that it suffers to a degree in much the same way as a growth target pure and simple from uncertainty about both the trend rate and the starting point. There are, too, familiar problems relating to the timeliness of nominal GDP data and the frequency with which, and extent to which, it has to be revised, compared with data on inflation.

The criticism that is sometimes made of *inflation targeting*—and the reason perhaps why some people would prefer to target nominal income—is that it focuses only on price stability to the neglect of stabilisation of output and employment. If this were true, it would be a serious criticism because policy would be failing to address some of its fundamental objectives. I think, however, that this criticism is misplaced.

As we saw from our earlier experience there is no trade-off between inflation and growth and employment in anything other than the short run. In creating a permanently stable price environment we can in fact enhance the prospect for growth and employment through encouraging more rational, longer-term, decision-making.

But there is no necessary conflict between inflation and output objectives even in the short run. To illustrate the point let me take the example of the recent slowdown in domestic and particularly external demand growth here in the United Kingdom. Because it had a depressing influence on both prices and activity, monetary policy could be eased—wholly consistently with the inflation target—as indeed it was. Shocks to the supply side of the economy pose potentially bigger problems, because they do tend to affect prices and output in opposite directions. The rise in world commodity prices in 1994 and 1995 would be an example. In practice what tends to happen in this case is that policy accommodates the initial first round price effects rather than trying to offset them, but then tries to ensure that they do not have second-round domestic inflationary repercussions. This may, I accept, involve restraining domestic activity in the short term.

A forward-looking approach to inflation targeting does therefore necessarily take account of what is happening or likely to happen to the real side of the economy—output and employment—because this influences the outlook for inflation itself. In focusing on inflation over the medium and longer term, we are in fact using it as a barometer, if you like, of the prospective balance between aggregate demand and the supply capacity of the economy. In this sense it is not in fact so far removed from stabilising output and employment around their trend rates, except that instead of seeking to estimate those trends directly—which as I say

is a hazardous process—we monitor the prospect for inflation as evidence of an emerging imbalance between them.

Now it has to be said, Vice Chancellor, that our experience of a monetary framework based upon an explicit inflation target is still rather limited. The inflation target was introduced less than four years ago, and the supporting arrangements for making the policy process more transparent, through the Bank's independent quarterly *Inflation Report* and through the publication, six weeks in arrears, of the minutes of the monthly monetary policy meeting, which I and my senior officials have with the Chancellor, are somewhat more recent.

But the results so far are encouraging. Inflation itself over the past four years, on the target measure, has averaged 3.0%. This compares with an average of nearly 10% in the 20 years before we adopted the inflation target in 1992, including one single year when inflation rose by nearly 25%. Notwithstanding the various shocks that I have described (for example rising world commodity prices and weak economic activity in continental Europe), activity has grown consistently—and reasonably steadily—for 16 successive quarters. Unemployment has fallen fairly steadily during this period, from a peak of over 10½% to below 8% now. And the prospect for the next two years—the extent of most forecasting horizons—remains very encouraging, with most forecasters predicting continuing steady growth with low inflation, within a range, in each case, of some 2%–3% a year.

On this basis I believe that stability—not just price stability, but stability in the broader macroeconomic sense that I have described, including steady growth and lower unemployment —is closer than it has been for a very long time. I find that rather an exciting prospect—not in the least bit boring or dull, and I hope that you might share some of that enthusiasm, even after listening so patiently to this lecture!

Of course it is not yet in the bag. We have to persist year after year before we really will have persuaded people, and industrial and commercial businesses, and financial markets, that stability is a permanent, normal, state of affairs on which they can rely. But if we can succeed in establishing macroeconomic stability in this way, that will allow policy-makers in other areas to concentrate on the structural features of our economy—the long-term, microeconomic, debates—that can raise our potential rate of growth and lower our natural rate of unemployment. That is what we also need to do to maximise economic welfare—and it will provide plenty to debate and argue about.