Monetary policy in Britain and Europe

*The **Governor**[(1)] reviews the recently announced changes to the UK monetary policy framework, in the context of the approach to economic management throughout Europe. He identifies a broad consensus on the need for monetary policy to be directed towards stability and sustainability in the medium and longer term, and a growing recognition of the importance of supply-side flexibility. The **Governor** compares the new UK monetary policy arrangements with those planned for Europe, and concludes that the essential similarities are much greater than the differences. He warns, however, of the potential risk to monetary union posed by very high and differing rates of unemployment in the European Union.*

I was delighted to have been invited to deliver the sixteenth Mais Lecture—until some two or three months ago when you asked me to suggest a title! I confess that at that stage, I had not really thought of what I should talk about. So I offered you the portmanteau title of 'Monetary policy in Britain and Europe', hoping that something would turn up either here or on the Continent to give some topicality to what I might say. Well happily, Vice Chancellor, it has. On 6 May, just four days after taking office, the Chancellor of the Exchequer announced some radical changes to the monetary policy framework in this country, including changes to the role and constitution of the Bank of England. I should like to discuss some of those changes this evening against the background of the monetary policy framework being developed in Europe in preparation for the introduction of the euro, including the role of the future European System of Central Banks (ESCB). But I should like to discuss them in the context of the approach to economic management more generally in Europe and this country, and perhaps I might start with that.

Overall EU economic management

Sweeping generalisations are of course always dangerous. But from my particular vantage point at least, there has during the past decade or more been a clear change of emphasis—across Europe but much more widely internationally—*away* from short-term, macroeconomic demand management as the means of promoting the agreed objectives of economic policy (of growth of output and employment, and of rising living standards), *towards* the need for macroeconomic stability in the medium and longer term. Previously the implicit assumption appeared to be that the supply side of the economy would respond relatively flexibly to increasing demand. But there is now the perception that overambitious short-term demand management, which attempts to push capacity to its limits or even beyond, can generate instability and uncertainty, damaging capacity growth in the longer term by distorting economic decision-making in relation to, for example, investment or resource allocation.

The result is a broad consensus—across countries but also across a wide part of the political spectrum within countries—on the need for macroeconomic policy to be directed towards stability and sustainability in the medium and longer term. This consensus is reflected in the Maastricht Treaty through the famous convergence criteria. It is reflected, too, in the arrangements for the conduct of macroeconomic policy now being put in place for the introduction of the single European currency, including the monetary preparations for the European Central Bank (ECB), and the agreement on the fiscal Stability and Growth Pact recently confirmed by the European Council in Amsterdam.

But alongside this collective commitment to macroeconomic stability, there is a growing recognition that stability on its own is not enough. Though it may be a *necessary* condition for achieving sustainable growth of output and employment and rising living standards—the truly good things in life—and though stability may indeed be the most that macroeconomic policy can contribute in the longer term to those agreed objectives, it is not in itself a *sufficient* condition for achieving them. So attention everywhere is now focusing increasingly on the structural characteristics of our economies which essentially determine their underlying, supply-side, rate of capacity growth.

The issue is starkly illustrated by the fact that despite very substantial progress towards macroeconomic stability within the European Union as a whole in recent years—including real progress towards effective price stability (with measured inflation now below 2%) and strenuous efforts everywhere to cut back public sector deficits as required by the Maastricht convergence criteria—output has stagnated, growing at an average annual rate of only 1% or so over the past five or six years, and unemployment has risen inexorably, to around 11% across the Union as a whole. And though it is true that activity may now be beginning to recover, this is very largely driven by external demand, with the EU domestic economy still depressingly weak.

(1) In a lecture given at the City University Business School on 24 June 1997.

Against this background, the need for greater supply-side flexibility within Europe is increasingly widely acknowledged. And there are elements of common approach to bringing it about. These were reflected, for example, in the Resolution on Growth and Employment adopted at the European Summit in Amsterdam a week ago, which talks of the need to improve European competitiveness—with special attention to be given 'to labour and product market efficiency, technological innovation and the potential for small and medium-sized enterprises to create jobs'. It talks, too, of improving 'training and education systems, including life-long learning, work incentives in the tax and benefit systems and reducing non-wage labour costs, in order to increase employability'. But these policy approaches are not well-defined across Europe, and it is probably at this stage stretching a point to speak of even a broad consensus on specific approaches in this area. Even where particular needs for change have been identified nationally, recent experience in some countries suggests that there can be formidable resistance to bringing it about.

The new Government in this country is clearly joined in the European consensus on the need for macroeconomic stability; it too emphasises the importance of supply-side flexibility—indeed its thinking on supply-side issues clearly influenced the Amsterdam Resolution that I have just mentioned. To quote a recent article by the Chancellor:

> 'The Labour Government is committed to monetary stability so that businesses and families can plan for the future; to fiscal stability; and (on the supply side) to higher levels of investment in both people and business; to a modernisation of our welfare state, and, not least, to free trade and a constructive engagement in Europe.'

This country's approach overall to economic management is, therefore, wholly consistent with that of our European partners; and we start from a somewhat more comfortable position, in which our own recent progress towards greater macroeconomic stability has in fact been accompanied by somewhat stronger growth of activity—averaging over 2½% over the past five years—and by a sustained fall in unemployment to around 7¼% on a comparable International Labour Organisation basis.

Monetary management

Within this overall economic policy context, there is a particular commitment throughout the European Union to monetary stability; and I should like now to consider some of the very recent changes to our own monetary policy framework against that background.

Objective

I begin with the *objective* of monetary policy which, both here and on the Continent, is allocated specific responsibility for achieving and maintaining price stability.

The Maastricht Treaty states that 'The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies of the Community...'.

In his statement to the House of Commons on 20 May, the Chancellor said: 'The Bank [of England]'s monetary policy objective will be to deliver price stability, and, without prejudice to this objective, to support the Government's economic policy, including its objectives for growth and employment.'

At this level, our respective missions are effectively identical. But it is important to understand that price stability is not simply an end in itself, but a means to the end of *sustainable* growth. What we are really, in principle, trying to do in maintaining price stability is to keep the growth of monetary demand more or less continuously broadly in line with the underlying capacity growth in the economy—in effect using price stability as an indicator of stability in the economy as a whole. And though we cannot hope to achieve that in practice with any great precision, we can reasonably aspire to help to moderate the economic cycle rather than (as so often in the past) to aggravate it.

The Maastricht Treaty makes no provision for any further definition of the ECB's primary objective. It is left to the ECB's Governing Council to determine how to interpret 'price stability' in any particular circumstance. Indeed the ECB will need to decide whether it has a specific target for inflation at all, or whether, operationally, it adopts an intermediate monetary target, or elements of both.

In the case of the United Kingdom it is the Chancellor who determines the precise inflation target, which he has set at 2½% for the retail price index excluding mortgage interest payments; and the Chancellor reserves the right, in extreme economic circumstances, to override the Bank of England's operational independence in seeking to achieve the Government's target.

In practice, in either case, the degree of latitude that these arrangements apparently provide is likely to be limited by the need to maintain the credibility of the commitment to price stability, with financial markets and with the public at large. But in the United Kingdom at least, where public support for monetary stability is more recently established than it is, for example, in Germany, the elected Government's public and explicit commitment to low inflation may provide reassurance, and help to secure greater acceptance of the policy.

In any event the Bank's remit under the new arrangements is unmistakably clear. We are charged with delivering the Government's inflation target. Operationally that means that we are to aim consistently to achieve 2½% on RPIX as a *mid*-point, so that, with a balanced distribution of risks, there should be an even chance of outturns either above or below 2½% at the end of our two-year forecasting horizon. The measure of our success will be how close we in fact come to $2^{1}/_{2}$%, not on any particular date, but on average over time.

Transparency and accountability

The clear separation of responsibility for setting the inflation target (the political decision) from responsibility for achieving it (the technical decision) also helps to ensure that the Government and the Bank are separately accountable for their respective roles in the monetary policy process. And in this area of accountability too, there are considerable differences between the arrangements that will apply to the ECB and to ourselves.

In the case of the ECB, the Treaty requires that it 'shall address an annual report on the activities of the ESCB, and on the monetary policy of both the previous and current year, to the European Parliament, the Council and the Commission, and also to the European Council. The President of the ECB shall present this report to the Council and to the European Parliament, which may hold a general debate on that basis.' In addition the ECB President and the members of its Executive Board may be invited, or volunteer, to appear before the competent Committees of the European Parliament.

In the case of the Bank of England:

- The minutes of the Monetary Policy Committee's (MPC) meetings to determine interest rates will be published, identifying how each member voted, with an explanation of why the individuals who voted against were opposed to the majority decision.

- The MPC's performance will be reviewed regularly by a reformed Court of Directors, and the Bank's *Annual Report* will be debated in the House of Commons.

- The Bank will continue to publish its quarterly *Inflation Report*, reviewing both the outturn and the prospect for inflation in relation to the target; and the Treasury Select Committee will take evidence from the MPC on the *Inflation Report*; and

- as Chairman of the MPC, the Governor is required to write an open letter to the Chancellor if inflation strays by more than 1% either side of the $2^{1}/_{2}$% target. The letter would refer as appropriate to the *Inflation Report*, and explain why inflation was adrift, how long the divergence was expected to last, and the action taken to bring it back on course.

Taken as a whole, these arrangements provide for greater transparency of, and greater accountability for, the technical monetary process than anywhere else in the world.

Now I do not suppose, quite honestly, that anyone would particularly enjoy this degree of public scrutiny. But it will certainly help to concentrate the minds of the MPC members and it is, I believe, a necessary feature of our new arrangements.

The technical implementation of monetary policy, even with a very clearly defined objective, is not at all easy at the best of times. We have in practice a single instrument—the short-term interest rate—the precise effects of which on the economy are by no means perfectly understood, including by ourselves. We do know that it can take up to a couple of years or more to have its full effects. So we have to rely substantially on uncertain forecasts, which are subject to unforeseeable shocks. Policy judgments in these circumstances are necessarily an art rather than an exact science, no matter how much we apply science to informing those judgments. And the judgments themselves need to be constantly reviewed and frequently revised as relevant new information becomes available.

Transparency in these circumstances can only encourage a better informed public debate and a more sophisticated public understanding of the issues. That in turn can only help to strengthen confidence in the process—unless of course we make a frightful hash of it! I shall be surprised—and somewhat disappointed—if for similar reasons the ECB Governing Council does not go to considerable lengths to explain its policies to the public at large, even if it is not actually required to do so by statute.

The decision-making framework

Reflecting its multinational character, the policy-making body of the ECB, the Governing Council, will comprise the Governors of the participating country central banks plus the six members of the Executive Board. Our own MPC will comprise four 'outside' members directly appointed by the Chancellor, together with five Bank executives—the Governor, two Deputy Governors, and two Executive Directors. The common characteristic is that in each case the decision-makers will be professional experts rather than representatives of particular interests. Any doubts that this would in fact be the case in relation to the outside appointments to the MPC were certainly immediately dispelled when the names were announced: together with our inside appointees, they are, as a team, as well-qualified professionally for the task we have been set as I can imagine anywhere in the world—and we certainly need all the help we can get.

The processes of the Committee are inevitably still evolving. It will, as you would expect, be supported by the whole, considerable range of the Bank's monetary, economic, statistical and market expertise, supplemented by information from the Bank's network of regional agencies, with further front-line input both from the non-executive members of Court and from our wide range of industrial, commercial and financial contacts.

The Committee will be closely involved in the preparation of the quarterly *Inflation Report*, contributing to both the analysis and the forecasts. And of course, it will meet regularly on pre-announced dates each month—dates determined by the monthly cycle of statistical information—to take its decisions on monetary policy. These monthly meetings are spread over three days: a whole-day meeting to receive briefings from the Bank staff on the latest developments; an afternoon meeting to identify and discuss the important underlying issues and any tactical considerations there may be; and a final morning meeting to decide upon any necessary policy action. The Committee will need also to provide for emergency meetings in the event of a crisis, but if we are successful in our task of achieving permanent, long-term, stability I would hope that that will prove to be a very rare occurrence.

Implementation of policy

Compared with the complexity of the decision-making process in relation to interest rates, implementation of those decisions is relatively straightforward.

In the case of the ECB, the short-term interest rate will basically be contained within a corridor, bounded at the top by an overnight lending facility to the commercial banks, and at the bottom by an overnight deposit facility in which the banks can place surplus funds. Within the corridor the market interest rate will be steered by means of open-market repurchase operations. The ECB may also require commercial banks to hold minimum cash reserves with the system; and it will offer a limited amount of longer-term credit to commercial banks at market rates. Neither of these features appears to us to be necessary for monetary policy purposes, but they represent an element of continuity with the arrangements that currently apply in some prospective member countries.

In our own case the arrangements are even simpler. The decision on interest rates will be announced at noon following the final morning meeting of the MPC, and the chosen interest rate will be applied in our daily money-market operations—mostly these days through repurchase operations in gilt-edged securities. Limited facilities for late lending to the remaining discount houses and the settlement banks are available to ensure the smooth functioning of the payments system at the end of the day.

Looking at the monetary policy arrangements planned for Europe and as they now are in this country as a whole, it is clear that though there are significant differences of detail—such that our own arrangements would certainly require considerable further modification to make them compatible with membership of the ESCB—the essential similarities are much greater than the differences. Crucially, the primary monetary policy objective of price stability is the same, and the responsibility for achieving that objective is in each case entrusted to a broadly based group of technical experts not subject to political influence. That does not of course guarantee that we will, here or in Europe, succeed in achieving permanently greater stability but, perhaps presumptuously, I do think it gives us every chance of doing so.

Concluding remarks

I have tried this evening to draw attention to what I see as a very striking coincidence of basic approach to economic—and in particular monetary—management within Europe, and also between continental Europe and this country. We are clearly, it seems to me, on parallel tracks as far as our commitment to macroeconomic, both fiscal and monetary, stability is concerned, though we may be travelling at different speeds when it comes to supply-side flexibility.

That coincidence of basic approach is a prerequisite for sustainable economic convergence within Europe—without it, I do not see how monetary union could be on the agenda. But the question that is often then put to me is, if in fact we are on parallel tracks—in terms of our basic approach—why then do we not get on the same train and commit ourselves to joining monetary union? So let me conclude with just a few remarks on that subject.

The potential attraction of travelling together with our European partners is very clear. There would, other things equal, be real economic advantages in exchange rate *certainty* across the single market area, which can only be realised through the single currency. The same *certainty* cannot be achieved by the countries of Europe independently pursuing macroeconomic discipline, although that should over time help to minimise the degree of intra-European exchange rate volatility.

But there are real risks.

We are not all starting from the same station. Domestic demand in this country, for example, is currently growing at a rate that we cannot sustain for very long without the emergence of inflationary pressures. But in the major countries of continental Europe, on the other hand, domestic demand remains relatively subdued. The possibility of such cyclical divergences will not simply disappear on 1 January 1999 and they would seriously complicate the operation of a single monetary policy. So too would a variety of possible internal or external shocks that affected euro member countries in different ways or to different degrees.

But more fundamentally—and I cannot keep up the railway analogy—I am frankly nervous at the prospect of introducing the euro at a time of very high and very different rates of unemployment across Europe. It is not that I think unemployment can be addressed directly by more expansionary macroeconomic polices—that ought to be clear from my earlier remarks. I share the view that unemployment needs to be addressed fundamentally through supply-side policies—though it may be that the problem is currently being aggravated in the short term by the heroic attempts being made to meet the fiscal criteria according to the Maastricht timetable in a context of cyclical weakness. The problem is that we cannot be confident how individual countries may respond to this situation. My concern is that the persistence of these wholly unacceptable levels of unemployment across Europe, and the very real difficulty of implementing appropriate supply-side reforms, could begin to undermine public support for macroeconomic stability in some countries—even though significant relaxation on this front would provide at best only short-term relief. In that case, economic convergence, if it were achieved, could prove difficult to sustain. There are perhaps some suggestions that this may be beginning to happen; and it may be for this reason that the foreign exchange markets are implying that they expect relative euro weakness—to our own considerable embarrassment as a result of the corresponding strength of sterling's exchange rate. I have no doubt that, if the euro goes ahead, the ECB would in fact seek determinedly to exercise its statutory responsibility for maintaining price stability within the euro area. But its job would be enormously more difficult if this came to be seen, at least in some countries—however mistakenly—as an obstacle to the objectives of economic policy, including in particular increasing employment.

My conclusion from all this, is that whether or not the euro proceeds on the present timetable, and whether or not the United Kingdom is a part of that, the really important thing for European prosperity is that the present broad policy consensus holds together. But if we are to be able to hold on to macroeconomic stability—as we must—then we have to find answers to the urgent problem of European unemployment. That involves addressing the problems of supply-side flexibility as an immediate priority. And that, Vice Chancellor, is the message that the new Government has recently carried to Europe.