Recent economic developments and the MPC approach to monetary policy

*In his annual speech at the Mansion House, the **Governor**(1) reviews developments over the past year in both the global and UK economies, noting that major imbalances in both have complicated the task of policy-makers. Domestically, the economy is closer to full-capacity output, with a greater risk of overheating than for some time, but the serious imbalance between external and domestic demand has created some difficult questions for the Monetary Policy Committee. The **Governor** notes that it is not surprising that, within a common framework of analysis, the MPC members have reached marginally different conclusions, and that what were fine judgments have changed—and will change in future—with the facts, in either direction.*

My Lord Mayor, Chancellor, Ladies and Gentlemen.

The past year, since we last enjoyed the generous hospitality of the Mansion House, on this great City of London occasion, has been a testing time. It has been characterised by major imbalances both in the global economy and here in the United Kingdom—which have complicated the task of policy-makers everywhere, including the task of the Bank of England's Monetary Policy Committee (MPC).

Internationally, there has been good news in the enviable performance of the US—'Goldilocks'—economy, with continuing robust domestic demand growth and further falls in unemployment, with so far remarkably little inflationary pressure. To the extent that this performance can be sustained, it provides substantial underpinning for the global economy as a whole.

And there has been encouraging news, too, in the re-emergence of domestic demand growth in the continental European countries as they prepare to take the final step to Monetary Union. That is a promising context for the launch of a strong, credible currency and I wish the European Central Bank every success in its historic task. Domestic expansion with monetary stability within Europe is in the interest of us all.

Elsewhere though, the international situation has been decidedly less benign. A combination of financial fragility and weak business and consumer confidence has weighed heavily on the Japanese economy and on the yen; and the financial thunderstorms, which broke initially last year over a number of other countries in Asia, are still intermittently rumbling around the region and elsewhere. The economic fallout from these developments poses a serious downside risk to the growth of world activity, and threatens the emergence of potentially large international payments imbalances. It is a dangerous environment.

All of this has prompted a far-reaching re-examination of the international monetary structure, and in the meantime it presents the international monetary authorities with some difficult immediate management challenges. It also, of course, represents an uncertain international background for the conduct of monetary policy in this country.

Our own overall economic performance in the past year was again very encouraging. Output growth (on the latest data, to the first quarter of this year) was 2.9%—significantly above the rate of inflation (measured by the GDP deflator) for the fourth time in the past five years, which I think is unprecedented in post-war British experience. On this basis, annual output growth has averaged some 3.1% over the past five years, while annual inflation has averaged 2.2%. And unemployment (on the conventional claimant-count basis) fell further last year, to 4.8% on the latest figures, the lowest since the summer of 1980.

The task, of course, is to sustain this pattern of relatively steady growth with low inflation into the medium and longer term. And that task has certainly become much tougher.

At the aggregate level, looking at the economy as a whole, though no one—and I mean no one, whatever they may claim—knows with any great precision just where current demand and output are in relation to the underlying supply capacity of the economy, there is no doubt that we are now at least much closer to full-capacity output than we have been; and the actual rate of growth over the past year was, on almost anyone's calculation, above the rate of underlying capacity growth. So we have been at greater risk of overheating than for some time.

The consequence if we were to overheat is quite clear. Inflation would accelerate, and we would then need to impose an abrupt slowdown on the economy to bring it back under control to meet the Government's inflation target. It was, of course, to avoid accelerating inflation and the associated need for an abrupt slowdown that the members of the MPC last year had no difficulty in agreeing upon a significant policy tightening.

(1) In a speech given at the Lord Mayor's Dinner for Bankers and Merchants of the City of London on 11 June 1998.

But there was—and is—a significant complication. The aggregate position takes no account of the serious imbalance within the overall economy between external and domestic demand. The internationally exposed sectors of the economy were already confronted last year with an exaggeratedly strong exchange rate, particularly against the core European currencies, which could only partly be explained by cyclical and monetary policy differences. It appeared to have a good deal to do with market scepticism—I would argue misplaced scepticism—about the prospective strength of the euro. The internationally exposed sectors faced a further battering as a result of the economic impact of the developments in Asia and elsewhere that I mentioned earlier.

These pressures have had, and are having, a seriously depressing effect on demand and output in the exposed sectors of the economy—particularly, large parts of manufacturing industry and agriculture—which is contributing to a sharp deterioration in our balance of payments and a fall in the net external component of aggregate demand.

At the same time, the strong exchange rate and the weakness of world commodity prices are having a direct dampening impact on costs and prices in this country—particularly at the wholesale, producer level, but also affecting retail prices.

Meanwhile, the domestic economy has been unsustainably strong. Private consumption, in particular, was growing at an annualised rate of more than 5% last summer, and was still growing at an annualised rate of 4% by the first quarter of this year. This compares with a longer-term trend rate of some 2½%. But for the dampening impact of the external influences on aggregate demand and on costs and prices, this could already have resulted in accelerating inflation.

The complication for monetary policy, in this situation of external/domestic imbalance, has, of course, been that a tightening of monetary policy to slow the pace of the domestic economy would have been likely to aggravate the appreciation of the exchange rate, intensifying also the restraining external demand and price effects, and putting even more intense pressure on the internationally exposed sectors.

There is no question but that the strength of the domestic economy must moderate further—as indeed we expect that it will. But the external influences—which we can anyway not do much about, but which will in time wear off—made this moderation of domestic demand growth less immediately urgent than it would otherwise have been. In these circumstances, with some evidence that growth in the domestic economy was in fact slowing, and given the evident pressures on the internationally exposed sectors, we needed, in my view, to be more than usually confident in our judgment as to the need to tighten policy further.

The questions with which the MPC has been struggling this year then are: just how much shelter the external situation would in fact give us, and for how long; and just how much time, therefore, we had to bring about a sufficient slowdown in domestic demand to prevent inflation accelerating and the economy from overheating. Now these are immensely difficult judgments. They depend partly upon one's perception about the starting position—that is, how close we are to full capacity utilisation to begin with. And they depend upon not just the direction, but the rate of change and the timing, of changes in the different components of aggregate demand. It is hardly surprising that the various members of the MPC should, within this common framework of analysis, reach—essentially marginally—different conclusions, reflecting their individual judgments as to the balance of risks. Indeed it would have been incredible if they had not reached marginally different conclusions. What is unusual (and what outside observers are I think still getting used to) is that different possible interpretations of the data and different possible judgments are openly displayed in the minutes of our meetings, which also record the way in which each member votes.

Some people seem to find this open discussion of alternative views confusing. My own view is that it can only contribute to the effectiveness of monetary policy if the public at large better understand the nature of the issues and the uncertainties surrounding them. But our procedures have had one, by me at least, unforeseen, and I think regrettable, consequence, in that they have focused excessive attention upon how individual members of the MPC vote—leading to their over-simple categorisation as either hawks or doves. It is as if their judgments were expected to be consistently instinctive rather than objectively based upon their individual, open-minded assessment, reached after careful analysis, of the most recent information available at the particular time. As a result, serious economic commentary seems (perhaps temporarily) to have ceded some ground to ornithomancy—which, as of course you know, is the ancient practice of divining the future by observing the behaviour of birds—especially their flight patterns!

This, I suspect, contributed to the surprise reaction to last week's further rise in interest rates—which proved once again that 'Hell hath no fury like a wrong-footed financial commentator'! It should not have been such a great shock. In the *Inflation Report* that we published a month ago, we set out the analysis as I have described it to you this evening, and we drew attention to the fact that the outlook for monetary policy remained finely balanced—as it has clearly been for some months. We drew attention also to the major uncertainties surrounding the central inflation projection. These uncertainties included both the level of the exchange rate and developments in the labour market. It was—as we explained in our press notice last Thursday—the subsequent 'news' essentially on these fronts, and particularly the sharp acceleration in private sector earnings growth, that caused the MPC to conclude that the necessary slowdown in domestic demand growth had become more pressing. The interest rate decision showed simply that what were always fine judgments changed with the facts—as I can assure you they will in future, in either direction.