



BANK OF ENGLAND

Speech

Balancing the Economic See-Saw

Speech given by

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Mr Chairman, Distinguished Guests, Ladies and Gentlemen

I was delighted to receive an invitation to speak at your 187th Anniversary Banquet.

Plymouth people are brave souls. And few are braver than those who choose to listen to a central banker at 10 o'clock on a Friday evening. The more so, when I tell you that our ambition at the Bank of England is to be boring. Not, I hasten to add, at events like this. But in our management of the economy where our belief is that boring is best.

Macroeconomic policy has, for most of our lifetime, been rather too exciting for comfort. As Miss Prism told her charge in *The Importance of Being Earnest*, "Cecily you will read your Political Economy in my absence. The chapter on the Fall of the Rupee you may omit. It is somewhat too sensational".

If the rupee was too sensational, what words could describe the drama of sterling during the past fifty years? Devaluations in 1949 and 1967, eight week membership of the European "snake" in 1972, and the Exchange Rate Mechanism (ERM) which we joined in 1990 and left in September 1992. And now, of course, sterling's remarkable strength against the new currency of the euro. In short, the peripatetic pound has caused, and continues to cause, severe headaches for economic policymakers.

But was currency instability really the cause of those headaches in the past, or was it simply the effect of bad policies? Some of both is the answer. Large movements in sterling can create problems for monetary policy, as we have seen very recently.

Equally, the absence of a credible monetary framework means that the currency is likely to be volatile.

Sterling crises of the past reflected an absence of monetary stability. Inflation has eroded the value of money to the point where the purchasing power of £1 in 1950 has been reduced to less than a shilling, or 5p, today. The failure to control inflation led to excessive expansions of the economy, and the subsequent struggle to bring inflation back down resulted in severe recessions. This country experienced the sharpest decline in output of any G7 economy in the early 1980s. And in the early 1990s only Canada had a more severe recession. Eventually, the realisation that inflation did not generate sustainably higher output and employment produced a determination to restore stability to the UK economy.

Since our departure from the ERM, in September 1992, successive governments have put in place institutional changes that would deliver stability. First the inflation target and then independence of the Bank of England, with the new Monetary Policy Committee (MPC), have put us firmly on course to achieve monetary stability. And there is also now a clear fiscal policy framework to ensure that the public finances are in a sustainable state in the long run. The success of that approach can be seen in the remarkable degree of stability that the UK economy has achieved since the inflation target was adopted in October 1992. Over that period inflation has averaged 2.7%. And it has been more stable than in any period since monthly RPI figures were first collected in 1947. Output has grown at an average annual rate of 2.9%, well above the post-war average. Growth too has been more stable, and there have now been 31 consecutive quarters of expansion, the longest unbroken sequence since official records began.

Nevertheless, while monetary stability may be a necessary condition for exchange rate stability, it is clearly not sufficient. The evidence is the sharp rise in sterling against the euro over the past three years. Sterling is now some 40% higher against the euro than in late 1996. This is not the direct result of UK monetary policy - changes in interest rate differentials account for only a small part of the appreciation against the euro, and sterling has hardly changed against the dollar over the past five years.

Sterling's strength is largely the result of continuing weakness in the euro. That does, however, create problems - for some of you and for the MPC as well.

To maintain stability the MPC has an inflation target of 2½%. To meet the inflation target the MPC sets interest rates to keep nominal demand in line with supply at the target inflation rate. In that way it tries to maintain an overall balance in the economy. But sharp changes in either the exchange rate or the world economy - both of which we have seen over the past three years - mean that overall balance requires swings between external and domestic demand. The MPC can - and did - respond to external developments by changing interest rates so as to influence domestic demand to restore the overall balance. But in so doing the economic see-saw lurched with external demand falling and domestic demand rising. While the MPC can try to maintain stability in the economy as a whole it cannot prevent movements in the see-saw reflecting swings between external and domestic demand resulting from changes in the world economy. And lurches in this see-saw produce damage - as manufacturing and agricultural businesses know only too well, and as domestically-

oriented businesses saw in the early 1990s. Of course, the UK is not alone in this experience. So can we learn from others?

April is the month not just of showers; it is also the month of the Washington Spring meetings: the meetings of finance ministers and central bank governors from the one hundred and eighty-two member countries of the IMF and World Bank. Early tomorrow morning I shall leave Plymouth, rather as the Pilgrim Fathers, to travel to the New World to take part in those meetings. They provide an opportunity to take stock of the world economy. This year the key word will be "imbalances". The very word does not bode well for our attempt to balance the economic see-saw at home.

So I want to pose three questions. First, what are these imbalances? Second, why have they arisen? Third, do they make it more difficult to balance the UK's economic see-saw?

My first question, then, concerns the nature of the imbalances. Over the past year, there has been a marked recovery of the world economy as the effects on confidence and capital flows of the financial crises in emerging markets were quickly reversed.

In the words of the IMF, the global downturn following the crises of 1997 and 1998 "now appears to have been relatively mild and brief". Growth in most emerging markets has been impressive. But in the three largest economies of the industrialised world - the US, the euro area and Japan - economic growth has been lopsided. In the US, the extraordinary strength of consumption and investment has resulted in annual growth of final domestic demand of over 5% a year since 1996. Output grew impressively, but less fast, so the current account deficit has expanded and it is now not far short of 5% of GDP, a record level. Equally remarkable is the absence of sustained growth in Japan, where output is still no higher now than it was in 1996. A lack of consumer confidence resulted in falling domestic demand and a rising current account surplus. Less extreme is the euro zone, where, after a period of slow growth in the area as a whole, recovery is now well established.

The **internal** imbalances in each country - differences between growth of domestic demand and the supply of output - are the mirror image of the **external** imbalances - current account surpluses and deficits. Widening imbalances are unlikely to be sustainable for long. But the extent to which they will be self-correcting, or will require policy adjustment, depends in large part on why they have arisen.

This is my second question - why have the imbalances arisen? Sustained current account deficits can reflect profitable investment opportunities that exceed the supply of domestic savings so that it is necessary to borrow from abroad. And the most popular explanation of the recent rapid growth in domestic demand, especially in the US, is as the consequence of a rise in productivity growth, and investment opportunities, reflecting the so-called "new economy". It has been pointed out by several economists, including Alan Greenspan and my colleague John Vickers, that an increase in trend productivity growth might increase demand by more than it raised supply initially, as firms invest in new technology and consumers anticipate higher future incomes and spend today out of this revised estimate of their "permanent" income. Hence new information technologies, because they raise potential future output in the economy, would add to demand today. The immediate consequence of such an increase in demand relative to output is a current account deficit and inflationary pressures.

This is not a new point. It was prominent in the post-mortem examination of the UK boom and subsequent bust in the late 1980s. Nigel Lawson wrote in his memoirs "in the mid to late 1980s, there was a substantial upward revision of the permanent element [of income], particularly if we include capital gains, notably from home ownership. In part this was wholly justified, given the undoubted supply-side improvements that had occurred. But it clearly went too far". (*Lawson, N., The View from No 11, Bantam Press, 1992, p 632.*) And there is the rub. Provided the increase in productivity materialises, families and firms will be able to repay the debts incurred to finance the increase in spending. The levels of spending and output will converge, and the current account deficit will steadily subside. But if optimism has run ahead of reality, then, at some point an awkward downward adjustment to spending must take place. In such circumstances, the adjustment to quantities - both spending and the trade deficit - are likely to follow sharp adjustments in asset prices - both stock markets and exchange rates - when expectations come back into line with the underlying increase in productivity.

My final question was what does this mean for the economic see-saw in the UK? At present domestic demand is up and external demand is down. One way or another the imbalances in the world economy will be corrected. That is likely to go hand in hand with changes in exchange rates and other asset prices. Whether this will happen gradually or through a sharp adjustment is impossible to know. But those changes will have a major influence on the speed at which the economic see-saw in the UK will move back to balance.

The message for policy is that it is important not to let domestic demand grow too rapidly for too long. The longer the correction is left, the sharper the required adjustment will be. The higher one end of the see-saw, the greater the subsequent lurch will be. The trade deficit cannot continue to widen indefinitely. Hence, at some point domestic demand

will have to grow at below its sustainable trend level rather than significantly above as it has done now for some time - over 4% a year on average over the past four years.

By acting pre-emptively, and trying to anticipate developments, the MPC has been able to maintain overall stability in the economy, but the sharp rise in sterling led to a lurch in the economic see-saw. In one of the most influential contributions to monetary policy in the post-war period, Milton Friedman wrote that the characteristic of most central banks was that "too late and too much has been the general practice". Pre-emptive action to slow domestic demand growth to a more sustainable level is the key to avoiding a larger and more painful adjustment at a later date. That is why the MPC has raised interest rates by 100 basis points since September.

I hope you now understand why our ambition is to be so boring. Our aim is to maintain economic stability. A reputation for being boring is an advantage - credibility of the policy framework helps to dampen the movement of the see-saw. If love is never having to say sorry, then stability is never having to be exciting. Miss Prism should not have to tell future Cecilies to omit the chapter on the activities of the Monetary Policy Committee.