BANK OF ENGLAND

Speech

Monetary Policy and Manufacturing Industry

Speech given by

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Introduction

I was seventeen when I last spoke in public in the Black Country. That was in a debate at my old school here in Wolverhampton. After so many years I am delighted to have an opportunity to speak here again. As the saying goes, "you can take the boy out of the Black Country, but you can't take the Black Country out of the boy".

The Black Country of my childhood has changed. No longer do iron and steel works dominate the area causing "the ground to shake and the night sky to burn like the fires of hell". Other manufacturing industries, too, have declined or disappeared.

2 Manufacturing Industry

Nevertheless, the Black Country is synonymous with manufacturing industry. So I want to talk today about what monetary policy can – and cannot - do for manufacturing.

Since the Monetary Policy Committee (MPC) was set up in May 1997, inflation has remained close to its target of 2½% and economic expansion has continued. Policy has reacted to large swings in the world economy – the downturn in 1998 (following the Asian crisis and reduction in capital flows after the Russian default and devaluation) and upturn in 1999 – and to the prolonged strength of sterling. Interest rate changes have maintained stability in the economy as a whole. But manufacturing has been hit disproportionately, especially by the rise in sterling. Planning for the future is extremely difficult when there is such uncertainty about the future level of the exchange rate. So what can and should the MPC do about it?

Recent problems must be seen in their long-term context. Over the post-war period, the share of manufacturing in total output has fallen from over a third to around a fifth. Much of this decline is structural, the result of changes in demand and in the optimum location of business investment and activity around the world. It reflects the underlying shift in activity from the "old" to the "new" economies. The contraction of old industries is a consequence of the need for labour and capital to move into the expanding new industries. For example, although the output of the metal manufacturing and textile industries in the UK has fallen by around a third over the past thirty years, chemicals output has risen by some 140%. Even within engineering, traditional sectors such as metal manufacturing and machine tools have declined, and new sectors such as telecommunications have grown rapidly. Over the past year alone, the diversity within engineering has been very marked. The production of machine tools fell by 7% and of furnaces by 8%, whereas the output of office machinery rose by 21% and telecommunications equipment by a remarkable 66%.

Manufacturing has also been more volatile than the economy as a whole. Output in manufacturing fell in 10 out of the 28 quarters since the beginning of 1993. And the four-quarter growth rate varied between –1.2% in the first half of last year and +6.3% in 1994 when exports were growing rapidly. Over the period as a whole, manufacturing output rose at an average rate of 1.5% a year, about half that of the wider economy. This growth of total output has helped sustain the local economy. Despite the West Midlands reliance on manufacturing, its level of claimant unemployment has fallen from a peak of over 11% in 1993 to 4.3%, the lowest since March 1980, and now only slightly above the national rate of unemployment which is currently 4.0%.

But none of this takes away from the fact that manufacturers face real problems, most recently from a high level of sterling against the euro, and that they, indeed you, may in part blame the Monetary Policy Committee. You may feel that monetary policy should take special account of the position of manufacturing industry. I can certainly share the frustration of those who, having first created and then built up a successful business, find that its future founders on events totally outside their control. But what would taking special account of manufacturing mean in practice? Let me start with the exchange rate.

3 The Exchange Rate

Manufacturing has been seriously affected by the continued strength of sterling. Measured against a trade-weighted basket of currencies sterling has risen by around 30% over the past three and a half years. During that period manufacturing has continued to grow, but only by an annual average of 0.6%, compared with growth in the whole economy of 2.6%.

While sterling has been remarkably stable against the dollar, against the euro sterling has risen by no less than 40% since the autumn of 1996, and by 12% over the past year. As a result the trade deficit has widened. Last year the current account deficit was almost £13 billion, 1½ % of national income, the largest figure since 1990. The trade deficit in goods was over £26 billion. After recovering in 1999 as the world economy picked up, export volumes have fallen back recently. Still, over the past two years or so export volumes have held up more than might have been expected. The strain has been taken on margins. That is unlikely to be sustainable, as many of you will be all too aware.

Sterling's strength reflects euro weakness. The factors explaining the weakness in the euro are largely specific to the euro area itself. In broad terms, there are three factors which can help to explain exchange rate movements. First, movements in interest rate differentials tend to lead to a rise in the value of the currency in those countries where interest rates rise unexpectedly. Recent movements in sterling against the dollar have been small and are quite well explained by interest rate differentials. But changes in relative interest rates explain only a small part of the rise in sterling against the euro over the past three years. And when the MPC cut interest rates by no less than 2½ percentage points between October 1998 and June 1999, the exchange rate against the euro actually rose.

Second, market perceptions of changes in sustainable exchange rates in the long-run can affect current spot rates. Normally, exchange rates have a tendency to revert - albeit slowly - to long-run levels, at least when measured in real terms, that is adjusting changes in nominal exchange rates for movements in differential inflation rates. For example, over a very long period the sterling-dollar real exchange rate has tended to revert to a stable long-run value. But it is possible that the sustainable value of the euro is believed to be lower now than it was on average in the past. At present, the real euro exchange rate against sterling (using a constructed synthetic euro prior to 1999) is now lower than at any time in the past fifty years. Will this situation persist? No-one can be sure. The sustainable exchange rate must equate the current account deficit with the balance of investment over saving in the euro area at normal levels of output. There is little evidence from the behaviour of export and import volumes of a change in the sustainable exchange rate. So it seems rather early to conclude that there has been a permanent fall in the level of the real exchange rate of the euro.

Third, exchange rates move when the perceived risks of holding currencies change. Uncertainty about the new currency, and how it would be managed by a group of nation states, could well have raised the perceived risk of holding the euro, leading to a fall in the value of the euro against all currencies, including sterling. There is some survey evidence to support the view that the risk premium on the euro has risen. There is very little that the UK can do to influence the risks associated with holding the euro. But if the single currency is successful, then the perceived risks associated with the euro should decline over time. And if sterling really is seen as a somewhat safer currency than the euro then the market would be content to hold sterling at a lower overall return than on the euro. That is consistent with a market expectation of a somewhat steeper decline in sterling from its current high level than implied by differentials in interest rates.

All three factors – interest rate differentials, the sustainable level of the exchange rate, and the riskiness of sterling against the euro – imply that sterling is more likely than not – I would put it no stronger - to fall against the euro in the next two years or so. The timing and magnitude of any such fall are unknowable. But it is not surprising that the European Central Bank has concluded that the euro has “the potential for appreciation”. As with the dollar in the 1980s, it may take some years for that appreciation to occur, but in the long run the real exchange rate is likely to return to a more sustainable level. In the interim, although there is little that the MPC can do to influence the exchange rate, it can take its movements into account when setting interest rates. That it most certainly does. Because of the strength of sterling, interest rates have almost certainly been lower than would otherwise have been the case.

4 The Response of Monetary Policy

I know some of you may be thinking that the members of the Monetary Policy Committee just don’t care about manufacturing, don’t care about the West Midlands, and don’t care about the size of Britain’s manufacturing base. As hard-headed business people, I hope you would be dismissive of tea and sympathy, whether in Number 10, the Treasury, or the Bank of England. The question is, rather, what monetary policy can do to help, and what it cannot do. So let me try to answer three questions.

1. Would it help manufacturing industry if the MPC relaxed policy and targeted a higher inflation rate?

No: the problem facing many manufacturers is that output prices, and hence profit margins, are too low relative to the costs of their inputs. In large part, that reflects the strength of sterling. Higher inflation might, it is true, initially raise your output prices, but it would soon also raise your costs, as higher prices fed through to higher wages and increased costs of raw materials and intermediate goods. High inflation in the past did not raise manufacturing profitability, and led to a cycle of boom and bust which made life for manufacturers only more difficult.

2. Would it help manufacturing industry if the MPC targeted something other than inflation?

No: I think everyone now understands that the MPC sets interest rates to meet the 2½% inflation target. That ensures that inflation expectations are anchored on the target. If interest rates were set to achieve some other target, such as a particular, and presumably lower, level for the exchange rate, then, in present circumstances, inflation would be likely to move above the target. Inflation expectations would rise, losing their anchor, and we would be back in the inflationary cycles of the past.

3. Should not the MPC try to bring down the level of sterling?

Again, no: the value of sterling is set in the market and reflects expectations about future actions of central banks. The only way for the MPC to bring down sterling would be to abandon its commitment to meeting the inflation target. Not only would that be in breach of our statutory duty, it would undermine the hard won credibility of the UK’s commitment to low inflation. Central banks that undermine the value of their own currency are not trusted for long, and soon find that the fall in the exchange rate is much larger than intended. Monetary stability is not a fair weather policy.

So what has the Monetary Policy Committee done? Over the past three years, interest rates have moved both up and down in response to changing economic circumstances. Since September, the Monetary Policy Committee has raised interest rates from 5% to 6% in four separate moves. Those moves were pre-emptive. They took place at a time when inflation was marginally below its target of 2.5%. Looking ahead, beyond the time when the temporary downward pressures on inflation resulting from the rise in sterling begin to wear off, some action was required to reduce the pace of domestic demand growth. That was necessary to bring nominal demand into line with the value of potential supply of the economy at the target inflation rate.

To borrow a phrase, the MPC is pre-emptive for a purpose. Only by keeping inflation close to the target, and maintaining confidence among businesses and wage bargainers that inflation will indeed stay close to the target, can we hope to achieve overall macroeconomic stability.

Since 1992, when output started to recover after the earlier recession, the average annual growth rate of GDP has been 2.9%. Employment has risen by over 1% a year. Moreover, that growth has been remarkably stable. Its variability, as measured by the standard deviation of the growth rate, was half that in earlier decades. And the lowest growth rate of GDP over that period was 1.5% at the end of 1998 and the beginning of 1999. The deep recessions that the UK experienced in the 1970s, 1980s, and 1990s have been avoided, and there have now been an unprecedented 31 consecutive quarters of expansion. Overall, growth has been high and stable.

5 The Constituency for Low Inflation

There will always be pressure on the MPC to adopt the quick fix to deal with today's situation. But the task of the MPC – as given to us by the Chancellor – is to look further ahead and ensure stability in the longer term. That it why part of our mission is to build up a strong constituency for low inflation in this country. Support for low inflation will wane if it is based solely on the memory of the consequences of high and unstable inflation in the past. The positive attributes of low inflation and stability more generally, need to be understood, none more so than among the younger generation for whom the experiences of "boom and bust" are not even a dim memory. And that is why I am announcing today a new Bank of England/Times competition for young people in schools and colleges up and down the country. It will be called the Bank of England/Times Interest Rate Challenge. It will provide regular information on the state of the economy and the way in which monetary policy works, available in resource packs and on the Bank of England website, to all schools and colleges in the country. One of the main tasks of the MPC is to explain the case for price stability, gradually building the constituency for low inflation. And in the long run, manufacturing will benefit from macro-economic stability, for it is manufacturing that has suffered more than most from the swings between boom and bust in the past.

6 Conclusions

I know that some of you, perhaps many of you, but I hope not all of you, will be disappointed that I have promised no early or simple solution to the predicament of the strong exchange rate. To pretend otherwise would be dishonest. But I can promise that the MPC will do its best to maintain stability in the economy as a whole. In itself, that would change the economic environment in which manufacturing industry operates. And in the light of the history of economic performance in the UK over the 30 years since I left the Black Country, that would be no mean achievement. During those thirty years the value of money fell by over 90%. High inflation went hand in hand with a falling exchange rate. Sterling fell by over 70% against the Deutsche Mark. Manufacturing declined, growing by only half a percent a year, compared with 2¼% growth in total output. Monetary instability has not been good for manufacturing. The MPC is very conscious of the great difficulties facing many manufacturers as a result of the high exchange rate. But to abandon our newly won stability is no answer. I have tried to explain why there are good reasons to suppose that the present euro weakness is unlikely to persist indefinitely, and why, as that position is corrected, the problems posed by the level of sterling will, in due course, diminish.

Our aim is to ensure that inflation is no longer an important consideration in the planning of your businesses. That will not guarantee all of you a profitable future. But it does mean that long-term interest rates would remain much lower and much less volatile than in the past. That should encourage long term investment.

Ideally, the MPC would be almost invisible, so that you could take long-run stability for granted, and plan and invest for the long term as so many politicians have urged you to do in the past without providing the basis for it. The aim of the Monetary Policy Committee is to give you that platform. The rest will be up to you.