



BANK OF ENGLAND

Speech

Some Problems Facing the MPC

Speech given by

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To the Wessex Institute of Directors

10 October 2000

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I have been on the MPC since June of this year. During this time we have done nothing, in the sense that the interest rate has remained completely unchanged at 6%. This is not for want of trying on my part. In the meetings at the beginning of June, August and September I voted to raise interest rates to 6¼%. On each occasion a majority of the Committee voted against this. While this sounds as if I must be wildly at odds with many of my colleagues, in fact a difference of opinion about ¼ of a point would have been thought of as an entirely trivial matter in days gone by. And even today, it hardly represents a major divergence of views. But it does reflect some important uncertainties about where we stand, and it is these I shall discuss today.

The overall picture today looks benign. Since inflation targeting was introduced after we left the ERM about 8 years ago, inflation has been remarkably stable between 1½ and 3½ percent. Following its peak in 1993, unemployment has been falling steadily and now stands at a 25 year low. GDP has also moved ahead steadily over this period, its growth rate cycling gently around its long run trend of around 2½ percent. And while the economy has not been hit by any shocks as large as the first or second oil shock or the boom and slump of the late 1980s and early 1990s, there has been a financial crisis in the Far East and some dramatic swings in the exchange rate. However these have not moved the aggregate economy off course in any significant way. By comparison with the 1970s and the 1980s, the overall picture is one of remarkable stability on all fronts. Recalling how inflation went into double digits in both the mid 1970s and early 1980s, and GDP itself fell by 2 percent in 1980 and 1½ percent in 1991, things are now moving along in a very steady fashion, by comparison.

But underneath this calm aggregate picture, there is considerable sectoral turbulence generated more by exchange rate movements than anything else. Broadly speaking, since we fell out of the ERM the overall exchange rate has been low until 1996 and since then it has been high. Thinking in terms of the DM rate, it was well below 3 until 1996 and it has been fluctuating around 3.2 since 1997. More recently we have seen divergence with regard to the Euro and the Dollar with the Pound rising against the former and falling against the latter. After the recent intervention, the Euro has stabilised (at the time of writing).

What does all this mean? The problem is, it means different things to different people. If the exchange rate goes up a lot, the person in the street unquestionably gains. Basically, it means foreigners provide us with their goods more cheaply. For firms which, on balance, do more importing than exporting, a high exchange rate means more profits. For firms which, on balance, do more exporting than importing, a high exchange rate means less profit or worse. Things are, of course, even more complicated if the Pound rises against the Euro and falls against the Dollar. Then, for example, oil becomes more expensive because it is priced in dollars whereas imports from Europe become cheaper. Exporters to Europe lose whereas exporters to the United States gain.

The gyrations of the exchange rate is one of the problems facing the MPC. Why a problem? Because exchange rate changes not only have direct consequences for the well-being of individuals and firms, they also have consequences for inflation. Thus if the Pound falls against the Euro, this will have inflationary consequences both direct, via imports becoming more expensive, and indirect because the increased incentives to export lead to an increase in overall demand. But some firms are sorely in need of this boost. So the MPC has a potentially delicate problem. The overall inflation consequences of a fall in the exchange rate may encourage us to put interest rates up. But this may, of itself, slow down, or even reverse, the exchange rate fall. In fact, it seems to be the case at the moment that the large movements in the exchange rate are not greatly influenced by small changes in interest rates. The weakness of the Euro and the strength of the Dollar reflect strongly held views about where, currently, is the best place for investors to put their money. A quarter point on the interest rate is probably not going to change their minds in their current mood.

What other problems do the MPC face? First, there is the price of oil. In fact this is less of a problem for the MPC than it is for everybody else. While a rise in the oil price is both inflationary (petrol prices go up) and deflationary (people have less to spend on other things), we have a reasonable understanding of how such an increase pans out for inflation. So while we sometimes feel very uncertain about where the oil price is going, we do, I think, have a clear idea of the consequences of oil price shifts and how to respond to them.

More thorny problems are those connected with the labour market, productivity and the New Economy. While we may not yet have a new economy, we have certainly got a new labour market compared to the 1970s and 1980s. The question is, how much has it changed? We now have levels of unemployment not seen in a generation with evidence of a very tight labour market across large areas of Southern Britain. And yet the picture on the earnings front remains benign (although there is some evidence that pay settlements have been moving up in recent months). So how long can the labour market go on getting tighter before we see serious upward pressure on wages? This is something we are watching very closely, because we don't know the answer in advance. On the New Economy front, the situation faced by the MPC is equally tricky. Increased globalisation combined with advances in ICT are leading, on the one hand, to increases in competitive intensity and, on the other, to greater opportunities to cut costs and improve productivity. In the United States, this has produced a surge in labour productivity growth in recent years which can be seen clearly both by

people on the ground and in the aggregate economic statistics. This has enabled the US to have a dramatic boom without adverse inflationary consequences. The issue for the MPC is straightforward. Will it happen here despite our lower levels of R&D, and innovation more generally, relative to the US? It has yet to show up in the aggregate data but that does not mean that it is not already underway on the ground – it always takes a considerable time for these things to seep through into a clear trend in the aggregate statistics. We wait with interest for the fog to clear.

Both the last two problems I have mentioned have one thing in common. People on the ground will see things happening before they show up in the aggregate data. Thus people involved in wage bargaining and pay setting will be the first to get a feel for when wage inflation is going to start ticking up. People involved in organising production will be the first to know about whether ICT investments and increased competitive intensity are actually generating a surge in productivity. This is why the feedback we get from our network of Agents and from our discussions with people at the coal face, such as yourselves, is so absolutely crucial. The MPC has to try and be ahead of the aggregate data so your views on any of these issues are a vital input to our deliberations.