BANK OF ENGLAND

Speech

The CBI Annual Luncheon

Speech given by

The Rt Hon Edward George, Governor of Bank of England

25 February 2000

Thank you Chairman, Ladies and Gentlemen,

I would normally open my remarks on occasions such as this by saying what a pleasure it is to be here. But central bankers need to time their appearances before CBI audiences with very great care. And I've clearly failed on this occasion. The exchange rate is strong – many would say excessively strong – and the latest movements in interest rates have been upwards. Typically that is likely to mean that I've entered a lion's den! Well I hope you've all enjoyed your lunch as much as I have – because I once dreamt that Daniel, who must have been one of my ancient forebears, and who knew a bit about entering a lion's den, gave me some very good advice. He said to me in my dream "If you really must do it then make sure that the lions have been well fed first – they might just drop off to sleep!" Looking around, I see there is something in what he said!

Daniel also said "Whatever you do, don't provoke them!" Well at the risk of ignoring this advice I should like to establish just what sort of lions you all are! So I'd like to begin by taking an opinion poll!

I'd like to put to you two questions.

The first is how many of you agree that monetary policy should have the control of inflation as its overriding objective?

May I ask all those of you who agree that monetary policy should have control of inflation as its overriding objective, please, to raise a hand.

Now please would those who disagree that monetary policy should have control of inflation as its overriding objective please raise a hand.

Now let me ask you a second question – and I'm afraid that only those who voted in favour in response to the first question are entitled to vote this time – I don't want a biased result.

Given the objective of control of inflation – the 2½% inflation target – please would those of you who think interest rates should be higher than they are at present raise a hand?

Please raise a hand now if you think interest rates are at the right level?

And will those of you who think that interest rates should be lower than they are at present now please raise a hand – but remember you can only vote if you agreed that monetary policy should be directed to controlling inflation!

Welcome to your first meeting of the Monetary Policy Committee! Your votes will all be individually recorded by the Chairman and published with the minutes in a fortnight's time!

Now the point of all that was not just to help me decide how I should vote in the MPC next month! It was to distinguish two distinct issues relating to monetary policy that I want to discuss over the next few minutes.

The first is the objective of monetary policy – what it is that we, in the MPC should actually be trying to do. And that objective couldn't be clearer. It is to achieve – on average and over time – a target rate of retail price inflation, of 2½% on the RPIX measure (i.e. excluding MIPS), as set by the Chancellor of the Exchequer.

I suppose it might just be coincidence, but since we adopted inflation targeting as the objective of monetary policy, towards the end of 1992, our economy has performed remarkably well.

In fact over the past 7 years we have enjoyed the longest period of sustained low inflation we've known for a generation. Retail price inflation – on the Government's target measure – has averaged 2.7% over that time. That's just about 2% on the European standardised HICP measure of inflation – and on that measure our inflation rate is currently the lowest in Europe at 0.8%.

Alongside low inflation we've also had the lowest nominal interest rates that most of us can remember. Short-term rates have averaged some 6¼%, (fluctuating between 5 and 7½% over the period) compared with some 11¼%, (fluctuating between 7 and 15%) over the previous decade. And ten-year government bond yields have fallen from nearly 9% on average in 1992 to below 5½% at the present time. They were trading at one point this morning below 10-year German Government bonds for the first time for nearly 30 years – and they've been trading well below US Treasuries now for some considerable time.

But more than that, we have also over the past seven years or so enjoyed the longest period of uninterrupted, quarter-by-quarter, economic growth in the UK as a whole since quarterly records began in 1955. Annual growth since 1992 has in fact averaged 2.8%, which is between ¼ and ½% above most estimates of our long-term underlying trend rate.

We have also enjoyed an almost continuous month-by-month fall in the rate of unemployment, on a claimant count basis, from a peak of some 10½% at the end of 1992 to the present rate of just over 4% (or a little below 6% on the LFS measure). That is the lowest rate of unemployment since early 1980. And, finally, the number of people in employment is currently around the highest number on record.

I know that initially there were those who feared that low inflation could only be achieved at the expense of slow growth and high unemployment – and that may still be why some of you rejected low inflation as the overriding objective of monetary policy on the first vote. I think the facts demonstrate that this certainly need not be true. Low inflation is not simply an end in itself. What

we are really seeking to do in pursuing low inflation is to keep aggregate demand in the economy more or less continuously in line with the underlying capacity of the economy to meet that demand as a means to the end of sustainable growth. And I think that the facts that I have quoted are more consistent with the view that monetary stability – low inflation – can indeed contribute to sustainable growth.

But it may be that some of you voted no on the first ballot for the rather different reason – that with the monetary policy focus so clearly on low inflation we appear to ignore the strength of the pound – especially against the euro, which is seriously damaging many of the internationally-exposed sectors of our economy, including most of agriculture, much of manufacturing industry and also some services sectors, with differential regional effects. No doubt some of you are suffering from the strong exchange rate in your own businesses even here in London.

The question is what can we do about it. The problem – and it is our biggest problem in operating monetary policy at present – is not so much the strength of sterling – we have after all been remarkably stable against the dollar for most of the past five years – it is rather the surprising weakness of the euro. And while no one I think clearly understands just why the euro has been as weak as it has – particularly once the Eurozone economy began to pick up from about the middle of last year – the evidence is that it has not had as much to do with a change in relative monetary conditions as between the UK, and the US, on the one hand and the Eurozone on the other as is popularly supposed. It is in fact much more difficult to affect the exchange rate – directly through our domestic monetary policy – than you might imagine.

Of course we do take full account, in our forecasts and in our policy judgements, of the implications of the exchange rate, and of the international environment more generally, for our own economy. That was why we moved aggressively to cut interest rates a year or so ago. Sterling did not then fall against the euro as you might have expected – it actually rose. Even though we could not change the international environment, we were able to cushion its negative effect on the economy as a whole by providing an offsetting stimulus to the domestic economy. Had we not done so, we might well have suffered recession in the UK.

But the situation now is very different with the economy as a whole has strongly recovered and is now once again, operating close to capacity and apparently continuing to grow at above trend. So, even supposing we could influence the exchange rate in the direction we would no doubt all like to see – the hard question for us in current circumstances is could we – and should we – attempt to do so, in order to try to shelter internationally-exposed businesses, if that were to mean putting our objective of sustained low inflation at risk. In fact I've not heard anyone argue openly for that – and I would be surprised if they did. The reality is that if we were to put the economy as a whole at any significant risk of accelerating inflation – notwithstanding our mandate – we would not succeed in providing the intended protection even to the internationally-exposed sectors, except possibly in the

very short term; and we would jeopardise the prospect of sustained growth in the economy as a whole further ahead. That very clearly was what happened when we sought to hold the exchange rate down against the DM for a time in the 1980's.

There is no simple solution to this very real dilemma. And while I really do understand the pain that many internationally-exposed businesses are suffering, I'm afraid my vote must go with those who voted yes on the first ballot.

Now let me turn to the second – and quite distinct question – which relates to the practical operation of monetary policy. Even if we could agree on the consistently low inflation objective of monetary policy, we can all perfectly well nevertheless disagree about the appropriate stance of policy – the appropriate level of interest rates – to deliver that objective. You may just have noticed that the MPC members themselves differ more often than not on the policy judgement, though usually at the margin. And you clearly disagreed among yourselves, in our second vote just now. That's not at all surprising. I've often said that the people to be wary of – when it comes to views about interest rates –

are those pundits who purport to know with great confidence that they are right. The operation of monetary policy is an art rather than a precise science, though art is often all the better for being informed by at least a little science!

We start from a position where inflation is running – and has been running for some months – slightly below the Government's 2½%. The January figure was 2.1%.

Looking ahead – as we must, because monetary policy takes a while before it has its full effect – there is the continuing uncertainty about the strength of the exchange rate, which has of course had an important dampening effect on the rate of inflation. But beyond this, there are a number of unusual factors that might help to hold the rate of inflation down, at least in the short term. Some of these are one-off administrative measures rather than broader economic influences: they include the usually large price reductions imposed by utilities regulators to come into effect in the spring as well as the Chancellor's decision to end automatic over-indexation of excise duties on fuel and tobacco. But there is also evidence, which is harder to evaluate, of more intensive retail price competition, squeezing retail margins across the board, and that also could hold down prices at least for a time. Indeed this last effect could intensify and extend further into the future as a result of the spread of e-commerce.

Meanwhile we are faced with all the usual uncertainties about the prospective strength of domestic demand and about overall demand pressure – uncertainties which are currently increased by possible distortions of underlying trends associated with the millennium – the Y2K fog. Final domestic demand growth, including the growth of consumer spending, did apparently moderate in the middle of last year – as it needed, and certainly still needs to do. But there is plenty of evidence to suggest that underlying consumption growth will in fact remain quite buoyant: the strength of the equity market – or at least the "new economy" stocks; rising house prices – and not just in the South East; strong borrowing, including mortgage equity withdrawal, by the household sector; and rising incomes from employment.

Meanwhile, on the supply-side of the economy, there is little evidence as yet in the productivity data that would suggest an acceleration in the underlying rate of capacity output growth such as we have seen in the US, and which, while it lasted, would allow the economy to grow correspondingly faster without necessarily generating inflationary pressure. We might all fervently hope to become infected by that particular disease – but the actual evidence so far suggests that up to now we have remained immune. That does not necessarily mean that we will not see accelerating productivity growth. But we can't afford to gamble on that happening either. When people approach me with the sound-bite "give growth a chance" what I hear them saying is "take a risk with inflation". But equally when they say "you must take no risks with inflation" I hear them saying "the world will never change". The truth is that nobody knows with any great confidence. The important thing is to keep an open mind and to monitor intensively all of the data as they becomes available to us, and then draw what inferences we can as to how those data affect the balance of risks around the inflation target looking ahead. And that of course if precisely what we do in the Monetary Policy Committee.

Our latest Inflation Report forecast published last week – based on constant 6% interest rates, and on reasonable central assumptions about certain other key elements in the forecast – projects continuing overall output growth – of around 3% initially, moderating to around 2½% from around the end of this year – with continuing low inflation – at a rate of around 2% this year but rising back to around the 2½% target in the course of next year, with the risks – on these assumptions – modestly on the upside. But, given the current uncertainties, individual members of the Committee quite naturally prefer their own alternative assumptions about some of the key variables – most notably the likely future path of the exchange rate and the size and duration of the effect of the downward pressure on margins. And these varying assumptions could either raise or lower the rate of inflation two years ahead by up to ½ percentage point.

That, Mr Chairman, is all fairly technical stuff. The point to hold on to is that, on a reasonable range of assumptions, the prospect for the economy as a whole over the next couple of years is for continuing steady growth with low inflation, and most of us would happily settle for that. The debate is about just how strong the growth and just how low the rate of inflation. But we will be keeping that prospect under continuous review and be ready to respond to the evidence that emerges in the real world – in either direction.

You will have noticed that, although I disclosed my hand on the first ballot, I have not done so on the second. I will leave you to discover from the minutes of our future Monetary Policy Committee meetings how I vote in the real thing! And that, Mr Chairman, is as clear a steer as you are ever likely to get from a central banker on the likely future interest rate path!