BANK OF ENGLAND

Speech

The work of the Monetary Policy Committee

Speech given by
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14 June 2000

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I want to thank you very warmly for your kind invitation to lunch today. I particularly appreciate it because, for me, as a Midlander by upbringing, who went to school in Birmingham, it is a chance, more or less, to come back home. I learnt at school the healthy habit of never taking any expert, however erudite, at face value; and that means that I can quite understand why economics is regarded as a form of brain damage, and why someone once defined an economist as someone who sees something that works in practice, but warns you that it will never work in theory.

I want to try to suggest today that, while you must make up your own minds about the brain damage, the second proposition is not the case: basic prudent economic good management can work in practice, and indeed is working in practice in the UK today, even if the process is not always as straightforward as we would ideally like.

But because I still retain my scepticism about experts, I want to make this a two-way session. I will begin with a few words about how we see prospects for the UK economy, but I would then very much welcome views from all of you on how you see things from the perspective of your own businesses. All of us on the MPC spend a good deal of our time meeting business and other groups around the country precisely in order to try to get a first-hand impression of how the economy is progressing in different regions and sectors. We greatly value the feedback we get from these visits, alongside the continuous input we get from our Agents permanently based around the country.

Let me begin with an overall view. If you look at the performance of the UK economy as a whole over recent years - and I will come in a moment to variations in different regions or sectors - the picture is, by any standards, a fundamentally impressive one. The economy, viewed overall, has since the early 1990s achieved a continuing steady and sustained growth - in output and employment and personal wealth - without jeopardising low inflation and so without incurring the destabilising swings between boom and bust that so weakened the UK's economic performance in earlier years.

Since the present monetary framework, based on an explicit low inflation target, was adopted nearly eight years ago, we have enjoyed the longest period of uninterrupted growth achieved in modern times. Growth in output over this period has averaged around 2 3/4% a year, which is above most estimates of our long-run underlying trend; and unemployment has fallen from a peak of 10 1/2% on the claimant count at the beginning of 1993 to 3.9% at present. Importantly, the gains in employment have been shared around the country: the fall in unemployment in the West Midlands over the same period has been from 11.1% to 4.2%, and the picture is similar in other regions.

This sustained expansion in activity has been achieved with the best performance in terms of price stability that we have experienced for a generation: retail price inflation has averaged 2.7% over the period. With this has come markedly lower nominal interest rates, with short-term rates averaging some 6 1/4% compared with 11 1/4% over the previous decade; and the very welcome fall in inflationary expectations has enabled longer-term interest rates (10-year government bond yields) to fall to 5 1/4%, which (apart from a brief period last year) is the lowest we have seen them for nearly 40 years.

This sustained improvement in the UK's overall economic performance is the more remarkable when we remember that in 1998 we experienced a severe international disturbance in the wake of the Asian crisis. The downturn in Asia, accentuated by economic crisis in Russia, spread rapidly through the emerging market economies around the world and manifested itself in a sharp weakening in external demand felt by all the industrialised countries. In response, we cut interest rates, from 7 1/2% in October 1998 to 5% in June 1999, and in the year since then we have seen a strong recovery in activity in the UK economy. Through 1999, in fact, growth accelerated back towards and beyond its trend rate, and employment has continued to rise. It is precisely to ensure that this upswing in activity last year can continue at a sustainable rate, without generating overheating, that we acted pre-emptively through last winter to edge interest rates up to 6%, where they have stayed for the past four months.

There are now some signs that the pace of activity may be moderating to a more sustainable level. Growth overall in the year to the first quarter was running at around 3% a year, still somewhat above long-run trend. Inflation is currently running somewhat below our target of 2 1/2%. But cost pressures are still evident, particularly in the labour market, and may be reinforced if the exchange rate continues to ease, as it has in the past month. We need to remain vigilant, but, provided we take no risks with the progress we have made in recent years in maintaining low inflation, the prospect is for continuing growth overall on a basis that can be sustained into the medium term.

This overall prospect is an immensely encouraging one, and it is enormously important that we should not for one moment jeopardise it when we bring into the reckoning, as we should, particular features of the picture that may be creating strains for particular parts of the economy. It would be in no one's interests for the stability that has enabled the economy to grow so steadily in recent years to be undermined. Our first, and continuing, priority has to be to continue to deliver the stable monetary framework - of interest rates directed at maintaining low inflation - as a platform on which commerce and industry throughout the country can build their businesses and generate the growth in output and employment the country needs if we are to prosper on a continuing and sustained basis.

Within this encouraging overall picture, however, we have faced severe and unwelcome strains from the substantial rise in the exchange rate in recent years. No area of the economy has escaped the effect of these strains: agriculture and some service industries have felt them just as much as manufacturing. But the imbalance has undoubtedly been most severely felt by exporters, and by businesses most exposed to import competition; and that means that the effects have fallen most acutely on the manufacturing sector. The frustration felt by those who have built up efficient and competitive businesses, only to find their market position threatened by a rise in the exchange rate over which they have no control, is entirely understandable. Their experience has been, and continues to be, a significant feature in our judgment about the appropriate stance of policy for the economy as a whole. We believe it enormously important that we should look not just at the development of the economy as a whole, but also at how different regions and different sectors are faring - and indeed at differences within different regions and sectors. For that reason, the input from our twelve agents, whose job it is, located in all the main regions, to maintain continuous contact with local businesses and provide feedback to us on local conditions, has been extremely important in our assessment of developments in the economy. The feedback we get - that the rise in sterling has been, and is, causing severe strains - comes through loud and clear.

The imbalance created by the strength of sterling is as unwelcome to us as it is to the businesses affected by it, because it faces us with an acute policy dilemma. With the economy as a whole, as I have indicated, recovering strongly over the past year from the Asian crisis, led particularly by buoyant domestic demand, and in particular in the services sector, we have needed to moderate somewhat the pace of the upswing to ensure that price pressures, looking a year or more ahead, do not run ahead of our inflation target. In judging how far, and how fast, to moderate domestic demand, we have taken into account the weakness of the UK's external sector, and the impact particularly on manufacturing, as an immediate factor offsetting in part the buoyancy of domestic demand. But we have also had to take into account the possibility further ahead that, if the exchange rate moves back to more realistic levels, as we expect, the boost that could bring to external demand could only be accommodated, without strains on the supply capacity of the economy as a whole, if domestic demand has moderated. The rise in the exchange rate, and certainly the appreciation in the past winter, has been as unwelcome to us as to the businesses affected because of the acute difficulty of setting the appropriate policy stance for the economy as a whole when there are divergent pressures on different sectors of the whole.

The difficulty is compounded because, although sterling has eased back somewhat in the past month, it is very difficult to find a rational explanation for the rise sterling exhibited in the months before that, since the latter part of last year. The rise we saw in sterling from, roughly, mid-1996 to mid-1998, an appreciation of around 25% in overall terms, may have reflected in part a growing perception around the world that the UK economy as a whole was benefiting from the structural reforms put in place in earlier years, and that the framework within which economic policy was being conducted was sound and was commanding confidence. It also probably reflected cyclical factors, with the UK, along with the US, experiencing strengthening growth without inflation while activity in Continental Europe remained subdued. The rise was also in part accentuated by the Asian crisis, as the currencies of the emerging market countries depreciated. If these were the main influences at work, they related, welcome or unwelcome, to fundamentals in the economic environment, to which businesses could adapt over time. And indeed, it is impressive that so many businesses were able to generate cost savings and efficiencies to enable them to remain competitive internationally.

But it is hard to see that these factors can explain the rise in sterling in recent months. In fact of course, what we have principally seen in this more recent period has been not so much further gains in sterling as a persistent weakness in the euro. Hence we have remained in a fairly steady range against the dollar, and now indeed fallen somewhat against it. The exchange rate strains we have faced over the past year have thus been essentially a function of euro weakness rather than sterling strength.

It is not at all clear why the euro has been weakening. Some have suggested that it may reflect unfamiliarity with the new structure of European monetary union, and perhaps also uncertainty about progress in structural reform in individual economies in the euro-area. Whatever the reason, the fact of the euro weakening has added to the strains on UK businesses affected by the exchange rate movement, and it is of course of little comfort to them that it seems to reflect perceptions of the euro rather than any factors specific to sterling. But it does mean that, while there is little the UK can in itself do to offset the effect, it is reasonable to expect that the euro may in due course move back to more realistic levels; and that does indeed appear to have been happening in some part over the past month. Whether that will continue is hard to judge, but there are reasonable grounds for believing that some of the more extreme strains we have been experiencing from exchange rate movements may be abating. If that is so, it will be enormously helpful both to the balance of the UK economy as a whole and to the individual businesses most directly affected.

What would not help in this process would be for the MPC to take risks with our overriding responsibility for maintaining low inflation as a basis for the economy as a whole to continue to grow. To take risks with our inflation target in the hope of achieving some short-run impact on the exchange rate would be likely to do far more damage to the growth prospects of the economy as a whole than any immediate relief it might give to businesses suffering from the exchange rate, because the relief, if any were achieved, would be temporary, while the likely result would be the need for sharper interest rate rises down the road to rein back inflationary pressures built up in the meantime. Nor indeed is it at all clear that we would achieve any useful effect: when the MPC cut interest rates by 2 1/2 percentage points between October 1998 and June 1999, the exchange rate against the euro actually rose.

I have tried to deal frankly and openly with the dilemma the MPC has faced in recent months from this persistent weakening in the euro. I have tried to explain how we view the problem, and how we take account of the impact of the exchange rate, but also the limits on what we can do to resolve the dilemma. Let me end by touching on one other dilemma we face in setting interest rates - but in this case what I believe is an altogether more encouraging and exciting, if somewhat tantalising, prospect - the ‘new economy’.

By the ‘new economy’, I mean a series of different, but related, structural developments in the business environment that have been visible in recent years in the US, and have undoubtedly made a major contribution to enhanced economic performance there, and may come to have similar impacts here. The dilemma is that, while the benefits these developments can bring are undoubted, if and when they manifest themselves in enhanced economic performance, the evidence of their doing so in this country is, so far, piecemeal rather than conclusive.

The developments I am referring to are partly the product of greater flexibility in the structure of the economy and greater competitiveness. They partly reflect the increasing trend towards globalisation, of markets and of business processes. They reflect also the rapid advances being made in information and communications technology, and the application of these advances right down to the grass roots of business and commerce - better communication through e-mail, better price visibility through the internet, the development of e-commerce as an alternative retailing channel and for inter-company purchasing, and the application of ICT advances throughout the productive processes of individual businesses - in design and marketing, production control and distribution - to improve efficiency and responsiveness to customer needs.

The reason why these advances, if they are translated into actual improvements in our economic performance, are so exciting is that they represent scope for improvements in the supply side of the economy: they hold out the possibility that the economy might be able to grow faster than recent historical experience without jeopardising price stability. But precisely because they represent changes in the structure of the business environment, their economic impact is not easy to track and assessing that impact will need cool heads and careful judgment. The benefits may take time to come through. They may affect demand, as well as supply, in the economy, with implications for overall price stability that could go either way. The effects may appear in some areas of the economy before others. The process is inherently uncertain. For all these reasons, it will be extremely important that we do not anticipate the process and begin to award ourselves the benefits before we have seen concrete evidence that they have been captured in improved economic performance. There are promising portents, but relatively little concrete evidence yet, of the UK achieving the improvements in productivity that have so benefited the US economy in recent years. That does not mean that it will not happen here. But it does mean that we need to be both vigilant to avoid the pitfall of anticipating the gains before they arrive, and alert to capitalising on them if and when they begin to come through.

Let me end where I started. The impressive performance of the UK economy in recent years demonstrates, I believe, what can be achieved within a framework of continuing commitment to low inflation. There are dilemmas we face, as I have described, and there are limits to what monetary policy can do to relieve them. But that is simply a recognition of the plain fact that the continuing growth in output and employment we have achieved in recent years in this country is not something delivered by economic policy-makers: it is the product of the vigour and resourcefulness and dedication of hundreds of thousands of individual businesses across the country. The job of the MPC is to deliver a platform of continuing price stability so that business and industry across the country can continue to deliver the goods and services the market place wants. We shall continue to concentrate on our contribution so that you can contribute yours, to the benefit of the whole country.