



BANK OF ENGLAND

# Speech

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## Centre for Financial Studies Seminar

Speech given by

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I thought that what I might do this evening is to talk about the challenges confronting central banks - in the US, Japan, the eurozone and the UK in particular - and what can and what can't realistically be expected of them in the face of those challenges.

But I'd like to begin by discussing what it is that we are all trying to do. Let me start with our statutory mandates.

The Federal Reserve's marching orders are to "maintain long-run growth of the monetary and credit aggregates commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates". The Bank of Japan Law prescribes that "currency and monetary control shall be aimed, through the pursuit of price stability, at contributing to the sound development of the national economy". The primary objective of the ESCB "shall be to maintain price stability"; but, without prejudice to that objective, the ESCB shall support the general economic policies in the Community, which, in turn are designed (inter alia) "to promote ... sustainable and non-inflationary growth ... and a high level of employment". And the Bank of England is similarly mandated to pursue "price stability as defined by the (symmetrical) inflation target, and without prejudice to that objective to support the Government's economic policy, including its objectives for growth and employment".

Now the exact words of these mandates differ - to varying degrees. What's more we all have our own procedures and processes - in terms of the composition of our decision-making bodies for example, or the form and frequency of our policy meetings, or of our arrangements for public accountability. And our approaches to fulfilling our mandates vary from one central bank to another - some of us, for example, have a more precise target, or tolerance range, for inflation, or some provide a more explicit role for monetary aggregates within the analytical framework and so on. And much is sometimes made of these various differences. One can in fact spend many happy hours debating the finer pros and cons of one formulation as against another, and that can be a productive thing to do in pointing up the issues, though I think in the end my own conclusion is that circumstances alter cases - there's no unique best buy.

But I think that we need in any event to be careful that in pointing up the differences between us we don't exaggerate them. Because I have to say that in my experience - at a more fundamental level - we are all trying to do the same thing.

The essential instrument of monetary policy - control over short-term interest rates operates, through a number of different channels, certainly - on the demand side of our economies - primarily on domestic private sector demand. There is very little that monetary policy can do directly to influence the supply-side capacity of our economies to meet that demand over time, which is what determines the rate of growth that we can hope to sustain.

Improving supply-side performance is therefore fundamentally important and hugely more complex than overall macro-economic management of which monetary policy is a very important part. Our supply-side performance is affected by the whole range of public policy decisions. It is affected, for example, by the extent of free trade and market competition both nationally and internationally; by all forms of regulation, which have an important bearing among other things on the flexibility of goods and labour markets. It is affected by the level and structure of taxation on the one hand and of public expenditure on the other. And perhaps most fundamentally it is affected by the attitudes, and the technical and entrepreneurial skills of the workforce and management which, in turn, depends importantly on education and training. Decisions in these areas often involve difficult political judgements on how to strike the right balance between social and economic considerations. I shall have no more to say about supply-side issues in my remarks, except to thank my lucky stars that I was born a central banker and not a politician.

What in practice central bankers everywhere have to do is to try to keep aggregate demand growing consistently over time broadly in line with the underlying, sustainable, rate of growth of supply. And consistently low inflation is essentially the measure of our success in achieving that. Yes, we are all aiming for effective price stability, certainly. But that is not simply a doctrinaire end in itself - as is sometimes suggested, though not often here in Germany. It is a reflection, if you like, of our broader aim of achieving macro-economic stability in the much wider sense of a sustainable balance between aggregate demand and underlying supply. Insofar as we succeed in that aim we can hope thereby to moderate rather than aggravate cyclical fluctuations in the economy, and to remove much of the nominal uncertainty and related short-termism from economic decision-making. To that extent we can help indirectly to improve the supply-side performance of our economies. This is essentially the thought that underlies the universal central banker's mantra that "Price stability is a necessary condition for sustainable growth", not to mention sustainable high levels of employment and rising living standards, which are, of course, the really good things of macro-economic life.

Now it is relatively easy to explain in these terms what we are trying to do. Actually doing it is a good deal harder!

For a start we cannot directly observe or measure what is happening in an underlying sense on the supply side with any great precision. We may become aware of short-run shocks relatively promptly, and we are able to draw inferences from partial information over time. But we can't be confident we know just where the "target" is, and we will often need to approach it somewhat tentatively. And there are equally uncertainties on the demand side as to just what is happening

currently, or even more as to what is likely to happen in the period ahead. Nor can we know at all exactly just what the size of the impact of monetary policy action will be, or the timescale over which it will have its full effect, in the particular circumstances of any given situation. It has often been said that monetary policy is more of an art than a precise science even though we all bring to bear as much economic science as we can muster.

There are particular difficulties in interpreting movements in asset prices, including exchange rates, let alone seeking to manage them through monetary policy. And even if we have a view about the asset prices we might like to see in the broader context of our monetary policy objectives, it is often very hard to predict even the direction in which they might move, over even relatively long periods, in response to changes in interest rates. We necessarily take asset prices into account, both in our forecasts and in our policy decisions, but insofar as we cannot influence them directly we have to be satisfied with seeking to offset their effects on demand and inflation through other channels of the transmission mechanism. And the same is true, in a broader sense, of external demand shocks, which national or regional central banks cannot themselves directly affect, so that they must try to compensate for them through offsetting changes in domestic demand growth. What all this means, in turn, is that the most monetary authorities can hope to achieve is to maintain overall macro-economic stability; we cannot pretend that this means stable conditions for every sector of the economy, still less every individual producer.

Now let me be clear, I'm not pleading impotence! Monetary policy can have very powerful effects on overall macro-economic stability. But it is important that the limitations of monetary policy - what it can and what it can't hope to achieve - are clearly understood. Otherwise expectations are likely to be disappointed, and disappointed expectations may lead to building pressure for alternative policy actions, which may not in the event be in our longer-term economic interest.

Against that - rather long-winded - background I turn to the uncertainties in the present world economic situation.

The major uncertainty, of course, relates to the situation in the United States - the world's largest economy - which had experienced a period of exceptionally strong economic growth with relatively low inflation until the latter part of last year, which itself played a vital part in buoying up the whole world economy through the Asian financial crisis. Briefly - and no doubt oversimply - this very strong performance was made possible by developments on the supply side of the US economy in the form of exceptional productivity gains, as the application of new information and communications technologies spread through the economy. This development - though extremely difficult to quantify - promised a higher sustainable rate of growth in the US economy and higher corporate earnings growth. That expectation in turn contributed to a rapid rise in equity prices, especially in the "high tech" sectors, which helped stimulate both business investment in the US and consumer demand causing the private sector to move into financial deficit. It also attracted massive direct and portfolio investment inflows from abroad which over-financed an increasing current account deficit in the US and caused the dollar to strengthen against other currencies.

But by the first half of last year the US economy was expanding at a rate of around 5%, which even on the most optimistic view of underlying productivity growth was clearly unsustainable. The pace of demand growth in the US needed to slow down - as of course it has, dramatically, to the point where growth in the US in recent quarters has pretty well come to a halt.

The big questions now are whether we are at the low point, and what might we expect in terms of the strength of a recovery. And the reality is that no-one can be confident that they know the answers.

What we do know so far is that there has been a sharp downwards inventory correction and a contraction of investment notably in ICT which was so buoyant before, with associated declines in equity prices and in US imports. Consumption growth, supported by a strong housing market has so far held up rather better than might have been expected. Looking forward, on the positive side, one could point to the strong monetary policy response to the slowdown, and to the recent tax rebate, which have yet to have their full effect. There were some suggestions in recent capital goods orders figures that the rate of decline in investment spending may now slow. And the rate of inventory liquidation had stabilised pointing to a turn at some point so long as consumption continued to be reasonably well sustained. Consensus opinion, or so it seemed to me, had become modestly optimistic. At least that was the prospect until Tuesday and the appalling terrorist attacks in New York and Washington.

The immediate impact of those events was a sharp fall in already weak equity prices worldwide, and fears that the trauma would undermine confidence -including consumer confidence in the US, already vulnerable to rising unemployment.

Even before the terrorist attacks, the pessimist could point to the imbalances within the US economy, including the weakness of private sector savings, the overhang of past investment excesses, and the US external deficit, which would, at some point, need to be corrected. On that view one could envisage a gradual adjustment over time in which case the US might face a protracted period of near-stagnation; or - if you were really pessimistic - the adjustments might be more

abrupt, implying a period of negative growth and possible further financial instability. The tragic events on Tuesday will have encouraged such pessimism.

For what it is worth, while I recognise the downside risks, I remain - perhaps stubbornly - cautiously optimistic.

On the immediate situation, I was immensely impressed that the Federal Reserve and other US agencies have been able to keep essential payments and settlements services functioning as they have, which has allowed markets internationally to continue to function. And I was encouraged that equity markets in Europe yesterday recovered some of their immediate losses. Of course it is much too soon to assess the lasting impact of the events of the past two days. But the fundamental forces affecting the US economy have not changed. And in terms of confidence effects, it would be a mistake to underestimate the resilience of the American people in the face of adversity. Either way I can assure you that the monetary authorities around the world are actively co-operating to minimise the immediate damage, and that they will certainly be monitoring - continuously and very closely - the emerging evidence of more lasting effects. They will react to that evidence in the light of the likely impact on their own situation.

The US slowdown came at a particularly bad time for Japan. Japan was already suffering from a combination of weak domestic demand - particularly consumer demand - and supply-side constraints reflecting pressures on the banking system, heavily burdened with non-performing loans, as well as an acknowledged need for restructuring parts of the non-financial sector. Japan has pretty well exhausted the scope for macro-economic stimulus. Successive fiscal packages focussed on public works, and a sustained period of attempted monetary expansion, at near-zero interest rates in the face of deflation, have failed to overcome a high rate of precautionary saving by an ageing population facing an uncertain economic future. The policy emphasis of the new Japanese administration appears to have shifted towards firmer action to bring about supply-side reform in the belief that this will help to engender greater business and consumer confidence. The danger is that, to the extent that more aggressive restructuring results in bankruptcies and higher unemployment in the short term, that in itself might tend to weaken consumer demand for a time before the benefits of the restructuring come through. It is not clear to me at least that one can realistically expect much additional demand stimulus from monetary policy in these conditions, though no doubt the Bank of Japan is doing all that it can.

Here at home the euro area economy seemed comparatively well placed to withstand the effects of the US slowdown. For most of last year it had performed relatively strongly, with overall output growth at above its longer term trend rate and unemployment in the area as a whole falling from its earlier high peaks.

A problem, of course, was the recurrent weakness of the euro in foreign exchange markets, despite apparently strong "fundamentals" in terms of any conventional analysis. This euro weakness seemed to be explained by an outflow of capital, much of it drawn into the US by the strong attraction of prospective corporate earnings growth. I would be only too delighted if anyone here this evening could explain to me why the euro has not recovered more strongly than it has in the wake of the US slowdown!

The euro's weakness in foreign exchange markets gave rise to widespread criticism of the European Central Bank - not least in the British press, but also in some quarters here on the continent. That criticism in my view was wholly unjustified. It was a classic example of expecting too much from monetary policy. The role of a central bank is - as I said earlier - essentially to maintain overall macro-economic stability, and the measure of its success is consistently low inflation. On that criterion the ECB has been substantially successful. The Euro area economy grew at above trend with core inflation nevertheless remaining within the ECB's tolerance range of 0-2%, even though the headline measure of inflation, influenced by rising energy and food prices which were essentially shocks on the supply side, and by the weakness of the exchange rate, moved above that range. Had the ECB attempted during this period to target the exchange rate, presumably by raising interest rates, it is not at all obvious to me that it would have succeeded; and even if it had, the likelihood is that it would have put the internal stability of the euro-zone economy at risk.

More recently the ECB has sometimes been criticised as slow to respond to the weakening of the US economy. Implicit in that criticism no doubt is a strong conviction about the extent and duration of the US slowdown and its likely impact on the euro area. As I have said there is in fact a great deal of uncertainty about that.

But the ECB has had to take account, too, of domestic demand pressures within the euro area, and of the fact that, even on the core measure, Euro area inflation was moving up gradually to the top of the ECB's 0-2% range. Frankly I don't see how anyone can be confident whether the ECB had it precisely right or wrong - it is perfectly normal for even the best-informed people to disagree on these judgements, as anyone who reads our own Monetary Policy Committee meeting minutes will tell you. But I am wholly confident that the ECB is sensitive to the issues surrounding those judgements, including the downside risks in the US, as indeed it demonstrated a fortnight ago.

So, too, are we in the United Kingdom. In our case, we again enjoyed relatively steady overall economic growth through last year, combined with a further fall in unemployment to its lowest rate for over 25 years. Inflation meanwhile continued to run below the Government's 2½% target - and is currently running at around 1½% on the eurozone measure of

inflation. This relatively low inflation rate was partly a result of the dampening effect of sterling's surprisingly persistent strength against the euro. The problem for us - and it is a real problem which has been with us for some time now - is the sectoral (and associated regional) imbalance within our overall economy. The domestically-oriented sectors have, for the most part, been doing relatively well, whereas those sectors that are exposed to international competition, particularly within or from the Euro area, have been under considerable pressure. And that pressure on the internationally exposed sectors has of course intensified with the slowdown both in the US and in the euro area.

Understandably in these circumstances we too have been criticised, by many in the suffering sectors, for being slow to respond. They point to the fact that inflation has been consistently below what is intended to be a symmetrical target for the past two years, and they assume that had interest rates been lower over that period so, too, would the exchange rate. They sometimes, also, find it difficult to understand why, when our inflation rate is lower than in the Eurozone, and the US, our interest rates are higher.

In fact, the undershoot of the inflation target has been marginal over the past two years - averaging less than ½% and we tend to argue that - given all the uncertainties - it is unrealistic to suppose that we could get much closer to the target than that; we point out, too, that sterling has actually strengthened against the euro since the beginning of the year even though we have reduced our interest rate relative to that of the ECB. Our higher level of interest rates we explain as a reflection of the fact that we continue to operate closer to capacity than elsewhere and with a tighter labour market. I'm not sure that our critics are convinced, let alone mollified! But I do find it encouraging that they continue for the most part to support the policy objective of continuously low inflation even if from their perspective we are too rigorous in our pursuit of that objective!

We have in fact reduced interest rates by ¼% on four occasions so far this year. What is disappointing - both to us and our critics - is that while we have been able to compensate for the dampening effects of external factors - the exchange rate and the global economic slowdown - by encouraging stronger domestic consumption, we have not been able to alter the external environment itself, which is what our critics in the suffering sectors would really like to see. We have in effect increased the sectoral imbalance rather than reducing it. That may seem like second best but it is as much as anyone can reasonably ask of monetary policy.

Mr Chairman, I have gone on for too long and perhaps you will think that I have been overly-defensive both of myself and of my central banking colleagues. That was not my intention.

My intention rather was to explain what can and what cannot reasonably be expected of monetary policy in the present world economic situation. There are no easy or quick answers to the problems we are facing - and I'm tempted to say that if anyone thinks that there are then they probably don't understand the questions! But I am confident that persisting in our parallel attempts to maintain macro-economic stability in our respective currency areas provides the best way forward for the world economy as a whole. But it may be a somewhat bumpy road.