BANK OF ENGLAND

Speech

Monetary Policy: Addressing the Uncertainties

Speech given by

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The thoughts of all of us have turned, repeatedly over the past ten days, to the recent tragic events in New York and Washington. I want to touch on those events later in my remarks. But I want at the outset to express deep sympathy for the traumatic loss so many innocent people are suffering, but also admiration for the resilience and determination the American people are displaying. Our hearts and hopes are with them every step of the way.

Even before those tragic events, the UK economy, and the world economy as a whole, were facing many uncertainties. Grappling with these uncertainties is a difficult task, both for business enterprises trying to manage their own activities, and for policy-makers trying to maintain an environment in which business can flourish. The road through will inevitably be a bumpy one; and there are undoubtedly risks that the process will not be as comfortable as we would wish. But in my view, there are good grounds to believe that we can meet the challenge of steering through the present uncertainties and reaching more stable ground.

I want tonight to look at some of these uncertainties and explain how we are addressing them - and in particular, what monetary policy - the setting of interest rates - can contribute to the process - but also, what it cannot. In doing so, I want to offer some grounds for believing that we are well placed to weather the present uncertainties and that, if we can strike the right balance in setting monetary policy, there is a reasonable prospect of our coming through them in good shape to resume the path of sustained growth looking ahead.

It is undoubtedly helpful that the UK economy has, for the past several years, enjoyed an extended period of strong performance. Output has grown strongly at around the sustainable trend rate that we can hope to achieve. Employment has continued to rise and unemployment is at its lowest level for over a quarter of a century. Living standards have risen substantially. The strong fiscal position has enabled a planned programme to be pursued of increased public expenditure, designed to improve public services. Structural improvements in the economy have helped us in the challenge to maintain our competitiveness internationally, notwithstanding the strains that many businesses - including important sectors here in Scotland - have felt from the high exchange rate. Application of technological advances, particularly in the area of ICT, have helped improve the supply capacity of the economy, even though the extent of the improvement is, as yet, hard to judge.

Alongside all of this, inflation has remained low. It remains the Bank of England's particular task to keep inflation in line with the government's target of 2 1/2%. That is the part we play in trying to maintain the economy's strong performance. In doing so, we try to keep growth in overall demand in the economy broadly in line with the growth in its supply capacity, and thus help to ensure that the economy can continue to grow over time at a steady, sustainable rate that can be maintained on a continuing basis over the medium term. In this way, we can hope to provide a stable framework within which businesses throughout the economy can plan for the future on a long-term basis and thus deliver the steady growth in output and employment that is our common aim.

This task - setting interest rates to maintain low inflation, as a means to enable the economy to continue growing steadily at its sustainable rate - is a key contribution. But it cannot on its own insulate the economy from all the normal influences that affect its performance, be they cyclical shifts or sudden shocks. We are at present facing uncertainties from a number of influences of this kind, and I want therefore to look at some of them and explain how we are trying to address them.

Undoubtedly the major influence we, in common with other economies, are experiencing at present is the economic slowdown in the US and its impact across the world economy as a whole. For the past several years the US economy has experienced a period of exceptionally strong growth, helped by productivity gains engendered by the application of information and communication technologies throughout the US economy. This has been an enormously important factor in enabling the world economy as a whole to grow in recent years, and to come through the emerging markets crisis of the late 1990s. But during the course of last year it became clear that, with the US economy growing at around 5%, the pace was running faster than could be sustained. Some slowdown was therefore needed, and that is what we have seen happening during the course of this year. In addition, we have seen slower growth than expected in the euro area, continued weakness in Japan, and a number of the emerging market economies severely impacted by these developments. The question is how substantial and prolonged the global slowdown will be and what will its effect be on the UK.

Making that judgment is particularly difficult because the nature of the slowdown the US, and the world as a whole, is currently experiencing is somewhat different from previous cycles. The rapid growth the US was exhibiting up until last year was driven in major part by high levels of investment, seeking high rates of return in a rapidly-expanding economy. Inevitably, especially in a prolonged period of exceptionally strong growth, the process can become over-exuberant and not every investment achieves the rate of return expected of it. The slowdown we are seeing now reflects the judgment that investment had run too far. So we are for the moment seeing a sharp contraction in investment, and it is hard to see how far this adjustment will need to run before competitive pressures and the continuing rapid advance of technology leads firms to see the need to resume investment at levels necessary to sustain and grow their businesses. It may be helpful in that context that, given the pace of change, ICT investments typically have a relatively short economic life, so that today's systems may need replacement or upgrading rather sooner than conventional investment in basic machinery and equipment.

The strength of investment in ICT in recent years has not been confined to the US. It has been a world-wide phenomenon, with many firms significantly stepping up investment in the application of ICT to their businesses or in developing new products and services harnessing ICT technology. Across the world, too, many countries have developed electronics and ICT businesses focused in particular on supplying this rising global demand for ICT investment. Now, all too evidently, the pace of demand has, for a period, slackened. So, alongside the pervasive general effect of slower US growth, we are experiencing a world-wide sectoral slowdown in the ICT-related area. This has impacted particularly on many of the Asian economies; but its effect has also been felt around the world, including here at home in the highly competitive electronics businesses which Scotland has developed.

The question looking forward, even before last week's shocking events, was how long this adjustment was likely to take to run its course and how quickly we could reasonably look for some signs of recovery. This remains an area where no one can make any confident judgment. But the evidence has been far from entirely negative. In many of the major economies, there have been tentative signs that we might be at, or approaching, the low point. In the US, the impact of the necessary adjustment so far has been significantly cushioned by consumption spending continuing to grow relatively strongly, helped by a strong housing market. Importantly, with inflation remaining low, the US authorities have been able to cut rates substantially: that and the tax cuts currently being disbursed should provide an important support for domestic demand. We may be unsure how long the process will take, but my own view is that no one should underestimate the resilience of the American people and the underlying strengths of the US economy. There remains every reason to be confident that those strengths will come through.

In the past ten days we have had to bring into the equation the impact of the tragic events last week in New York and Washington. We have been working closely with the Federal Reserve and other central banks to help the financial system overcome the immediate dislocation, and it bears testimony to the resilience of the financial infrastructure that essential financial activity, and importantly the critical processing of payments and settlements, has continued to function without significant problems. No one can yet judge the scale of the longer-run impact this trauma may have on consumer and business confidence and on the prospects for economic activity. But the direction of that impact and the associated risks are clear. Central banks have responded in recent days by cutting interest rates - in our case a 1/4% cut announced on Tuesday, to 4 3/4%.

This is the fifth time this year we have cut rates. This reflects the fact that the slowdown in world growth has inevitably had its impact on the UK. The impact has been evident in slower, though still positive, growth in the first two quarters of this year and in continued weak business conditions since then. The impact has been felt particularly by businesses focused on supplying overseas markets - initially predominantly manufacturing, but now also evident in the services sectors. Moreover, the impact - again principally on manufacturing and externally-orientated businesses - has been accentuated by the continued strength of the exchange rate. In fact, sterling has over the past year depreciated against the dollar. The high exchange rate has essentially been a product of the weakness of the euro against sterling and other currencies, the reasons for which have lain in perceptions about the euro itself rather than anything directly relating to sterling. That, of course, does not mean that the impact of sterling's high rate against the euro has not been a significant source of strain on businesses exporting to the euro area, and on those competing with euro area businesses. But it does mean that there is little the UK could itself do to alleviate these strains, other than to recognise them and take them fully into account in our assessment of the prospects for the UK economy, and hence for interest rates, as we do. On the domestic front, too, we have had to face, over the course of the past year, difficulties arising from flooding and transport dislocation during last winter and the lingering persistence of foot and mouth disease. Taken as a whole, business has undoubtedly faced difficult circumstances. I know this is true particularly of parts of Scotland, where agriculture, manufacturing and tourism have all experienced setbacks.

Against this background, the effect of the cuts in interest rates we have made has inevitably been to add impetus to domestic spending, and particularly consumption spending by the household sector. Thus we have seen sustained strong growth in retail sales, high growth rates in personal borrowing and a buoyant housing market. This in turn has helped to sustain demand in businesses supplying consumer goods and services to the domestic market.

It was of course precisely in order to sustain domestic demand in this way, and help to counterbalance the softening in external demand, that we have cut rates. The strength of consumer spending helps explain why employment overall has continued to rise; and the process has been reinforced by the continued expansion in planned public expenditure on better public services, evidenced for example in strong construction activity. Overall, this has helped to sustain activity in the economy as a whole. But it has inevitably served to increase the imbalance in the economy, between the weakness being experienced in those parts of the business sector directly exposed to the slowdown in world growth and the continued buoyancy of domestic consumption spending.

For monetary policy going forward, the challenge we face is to try to continue to strike a balance between these divergent conditions faced in different parts of the economy. We have one considerable advantage in trying to strike this balance - inflationary pressures have remained low. Notwithstanding some upward pressure on earnings, inflation has remained close to our target of 2 1/2%. Our target, moreover, is a symmetrical one: it is just as important that we be ready to ease our stance if we see inflation, looking ahead, likely to run below target, and the economy under-performing its potential, as it is for us to apply restraint if we were to see inflation likely to exceed the target over the medium term. We have, I believe, shown our commitment to this symmetrical approach in the way we cut rates three years ago in the wake of the emerging markets crisis, and in the cuts in rates we have made so far this year.

But assessing where to strike the balance remains a difficult judgment. If in the short run we go too far in boosting domestic consumption, we may find that, when world growth begins to recover, we have to act correspondingly more forcefully to restrain domestic demand in order to leave room for the recovery in external demand. Equally, we have to remember that interest rate changes work through the economy with a lag. The effect of the cuts we made earlier this year is still with us; and the impact of further cuts now will continue to be felt during next year and beyond. This is not to say that we should not respond promptly to the changing picture as best we can see, looking forward; but it does mean that we cannot expect to be able to fine-tune the pace of demand in the economy in the short run. We have to look ahead and try to strike the best balance we can between the current slowdown in the world economy and the prospects for some recovery next year, on the one hand, and the current strength of domestic consumption and the risks of that faltering as the current external slowdown works through the economy, on the other hand. That may sound complicated. But it can be put another way, much more simply: looking across the economy as a whole, and taking fully into account all the regional and sectoral variations we see across the country - which is why I am here in Fort William - we have to set interest rates to continue to try to keep inflation in line with our target looking ahead over the medium term.

I have tried to explain why, given the uncertainties we currently face, this is bound to be a difficult task. But equally I believe it is one we are well placed to tackle. The fact that inflation remains low, and that the underlying competitive strengths of the major economies remain in place despite the present slowdown, are in my view reasons to believe that we can steer our way through the present uncertainties to more stable conditions of sustained growth. The road, as I have said, will inevitably be a bumpy one, but if we continue to try to strike an appropriate balance in our policy stance, I believe that we can meet the challenge.