



BANK OF ENGLAND

Speech

The Policy Implications of Economic Imbalances

Speech given by

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Greetings.

Introduction

This is one of the first opportunities I have had to reflect a little on the many challenges which face us all on the Monetary Policy Committee, challenges which are of course not unique to us, but shared with our counterparts across the globe. Indeed, perhaps one of the themes which I hope will emerge from my remarks is that while it is easy to become absorbed with the difficulties facing the UK, circumstances of course are not easy just now for any of the major central banks.

Every twist and turn of the economic cycle brings its own catchword. To paraphrase another cliché, this is an expression which passes from being a novelty into common parlance without enjoying an intervening period of meaning.

For the UK economy in 2001, the word has been imbalance. To perhaps a lesser extent, even ahead of the shocking and terrible events of September 11, this was also true of the international economy. September 11 has of course changed the context in which everything is seen, and none of us are quite sure how important it will prove as an economic event, though the political significance could not be over-stated. But in this changed world the question of imbalances is still highly relevant. Indeed, the terrorist attacks may in retrospect come to be seen as the defining moment which puts a sharper focus on what had previously been a rather diffuse set of concerns.

In setting out the propositions which I intend to examine more closely, and indeed to some extent to challenge, I am probably slightly guilty of creating a straw man. However, it is certainly the case that the two propositions set out below can be found pretty frequently in commentary on the UK's economic situation in 2001, to the point of being regarded as self-evidently true:

- The existence of imbalances is necessarily undesirable (widening imbalances are generally described as suggesting the conjuncture is in some way getting worse).
- These imbalances pose a special problem for policy-makers – certainly the MPC is from time to time described as effectively facing a choice between lower growth (and missing the inflation target on the downside) and taking action which will make the imbalances wider (and therefore worse). At the extreme, cutting interest rates to sustain growth is talked about as if the existence of imbalances made this path into an economic cul-de-sac.

It is perhaps relatively obvious that these propositions are not self-evidently true. The real issue is how far they are true of the UK at present. Before turning to look at this, it is perhaps worth noting what a great variety of circumstances is often being summed up under the heading of imbalances. There are numerous contrasting trends which exist in the UK at present, about many of which concern can be expressed, and in most cases it has been expressed in the recent past, including:

- The contrast between a manufacturing sector which is again experiencing recession, and a private services sector growing steadily at its average growth rate of the past twenty years.
- Weakness in net exports while domestic demand expands robustly
- Companies in tradeable sectors facing depressed demand and low margins, while in non-tradeable sectors profits remain strong
- Corporate sector becoming more reluctant to invest as confidence declines, while the personal sector is minded to acquire more debt
- Slow growth in industrial output, but rapid growth in retail sales
- A weak profit share, by historical standards, while real wage growth has been sustained
- A North-South divide or more accurately manufacturing regions which are faring less well, and overfull employment in the South-East.

All of the above are to some extent accurate descriptions of features of the UK in 2001. But that does not mean they are all problems needing to be addressed, and certainly not that they are all issues for monetary policy in particular. The list also gives rise to a fresh set of questions:

- How far are the imbalances interlinked, and how far do they stem from the same economic shock?
- Are these balances unusual by historical standards, or just the kinds of variation around the central economic tendency that would usually be expected?
- When does an imbalance matter for policy-makers in general, or for monetary policymakers in particular, and what should or could be done about it?

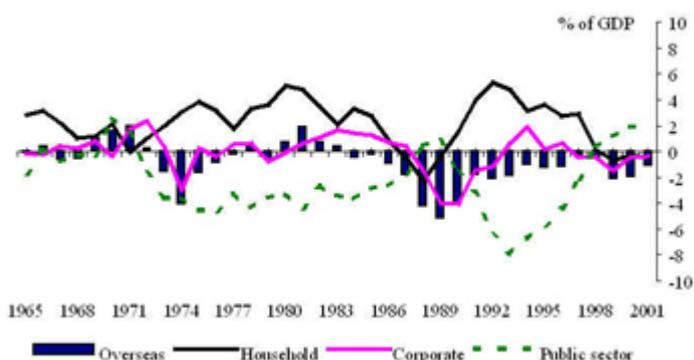
It is certainly not clear that an imbalance gives rise to an issue for macro policy rather than micro. For example, a sectoral problem, or a large corporate closure, can hit a region hard, and in this case micro-policy responses would more naturally be reached for: striving to re-skill the workforce and to attract new industries to prevent long-term decline and underperformance. This is a matter for the DTI and the Regional Development Agency in England, and here of course for Scottish Enterprise and the Highland and Island Enterprise, not a matter for the MPC. This does not mean, of course, that what is happening in the regions is irrelevant for monetary policy. We want to know what is going on in order to build up a picture from the bottom, as well as from the topdown messages of the national accounts data.

These generalisations also conceal a wide range of varying circumstances. Looking at Scotland, manufacturing performed better than manufacturing in the rest of the UK during the late 1990s, as the strength of the high-tech sector outweighed the problems of the strong exchange rate and intense global competition. However, more recently Scotland has suffered from the decline of the high-tech sector and from apparent weakness in other parts of manufacturing. So Scotland has moved from bucking the trends of weaker manufacturing and the North-South divide towards being an example of both.

The right question to ask is when do these micro problems of industrial restructuring, or balance sheet adjustments, become macro-issues? The conventional way to approach this question is by looking at the four main financial imbalances in the economy. But it is also important to the micro stories behind the imbalances to improve our understanding of what the key drivers are, and from that whether any corrections are likely which will affect the future course of the economy.

In the rest of my remarks, I aim to set the UK's present imbalances into a wider context and discuss a bit of economic history from the last cycle to draw out a few relevant comparisons. I then describe the UK's present imbalances in a little more detail, comment on how adjustment could take place and then conclude with remarks on the policy implications.

UK financial balances



The present UK imbalances in context

The main macroeconomic balances in the UK can be readily described. Since 1997, the UK has had a growing current account deficit which is likely to be around 2% of GDP this year. The domestic counterparts have seen a move by the household sector from significant surplus into a small deficit of 0.3% of GDP in the second quarter of 2001, and a shift by the non-financial corporate sector from a less significant surplus into a deficit of 1.3% of GDP. The financial sector has moved into a significant deficit. These deficits are partly offset by the public sector which has been in surplus since 1998.

The natural comparison for this situation is the late 1980s, when in the 'worst' year, 1989, the current account deficit reached 5.1% of GDP, and the corporate sector deficit was 4% of GDP. For households the deficit peaked a year earlier at 2.2% of GDP. The causes of this situation were a very rapid growth of domestic demand, driven by financial liberalisation which pushed up consumer borrowing, together with an expectation by the private sector of a persistently faster rate of growth. The corporate sector's move into deficit was initially the result of increased investment, reflecting optimism not just about the UK economy, but also about the European economy more widely. The conventional wisdom for a time looked ahead at the approach of the EU Single Market (which came into effect on January 1, 1992) and at the break-up of the Soviet empire, and drew the conclusion that the period of eurosclerosis could be safely forgotten.

Rapid growth in business investment was by no means confined to the UK among the major EU countries in the 1987-89 period. Business investment in the EU area grew by more than 25% over those 3 years. Consumer spending was also generally strong. In both cases the UK boom was, however, particularly strong.

Looking at the imbalances in the UK at present, there are two different and reinforcing main causes. One is the exchange rate, which has been considered to be over-valued on many estimates, mainly against the euro (previously the DMark) since 1997. Attempts to account for the scale of sterling's very rapid rise in 1996, the subsequent overshooting of the exchange rate judged to be the equilibrium and then sustained overvaluation have generally found only partial explanations.

The effects of this sustained overvaluation include the trade deficit, which has risen from around zero in 1997 to over 2% of GDP in the second quarter of this year, and stronger consumer spending due to the boost to real earnings. The related imbalance which has given most cause for concern is the contrast in the corporate sector between the tradable and nontradable industries.

The other driving force behind the emergence of imbalances lies within the personal sector, where the mid-1990s period of consumer caution combined with a high savings rate has been replaced by a renewed appetite for borrowing. It is not surprising that this has occurred, given a number of favourable factors. The public sector finances are now in better shape, so that households have more confidence that present levels of taxation will be sustained into the future. Unemployment has fallen steadily, with several parts of the UK in a position of full employment. Like the late 1980s, confidence in future growth has risen and this was one factor in the higher equity prices which until recently boosted household wealth. In addition, sustained lower inflation and lower interest rates have increased the capacity to borrow.

Imbalances elsewhere

The UK is not alone at present in having imbalances, and a look at the major economies over the past twenty years yields other examples, notably the US twin deficits in the early 1980s.

A sustained period of current account deficit is not unusual. While the US is the most obvious example (having recorded only one, very small, annual current account surplus in the last twenty years, which include eight years in which the deficit was greater than 2% of GDP) – there are other examples of countries sustaining significant deficits for a number of years. The most striking is probably Australia, which has seen a current account deficit in excess of 3% of GDP each year for the whole of the 1990s, coupled since 1993 with strong growth.

Nor is it unusual to see significant changes in household savings ratios, as economic circumstances alter and encourage individuals to find new equilibrium levels of debt. The household savings ratio has declined in both Germany and Spain during the late 1990s as fiscal consolidation has occurred – and this trend has been even more marked in Italy (where OECD data indicate a fall in the savings ratio from over 20% in the 1980s to around 10% presently).

Boom and bust - the UK in the late 1980s and early 1990s

However, it is certainly true that the last set of imbalances in the UK led to a very painful adjustment in the UK, and there are some parallels with the present situation, though also significant differences. While the imbalances were still accumulating in the spring of 1988, the National Institute was expressing concern about the current account deficit – saying 'even if foreigners were prepared to go on lending at an increasing rate to British consumers for ever, it is questionable whether this is an outcome for the economy which policy should encourage.' This is not dissimilar to some of the views on imbalances which are expressed today.

Rising interest rates did start to slow the economy in 1989, but consumer spending still remained fairly robust (met to a large extent by imports) and inflation rose sharply. Consumer spending started to slacken during the summer of 1990, and fell back more sharply after Iraq's invasion of Kuwait with the associated rise in the oil price. Inflation peaked in the autumn of 1990, and the economy remained very weak in the first half of 1991 as the impact of an export slowdown when the Gulf War occurred added to the downward pressure on activity from tight monetary policy. Recovery was to prove a long time in coming, despite cuts in interest rates made as sterling's performance in the European exchange rate mechanism permitted - not until the second half of 1992 did GDP growth return to around the long-term trend rate.

It would be difficult to argue that Iraq's invasion of Kuwait and the subsequent Gulf War were prime causes of recession – but it is certainly true that these events led to a slowing of the global economy which, combined with the UK's tight domestic policy, brought an end to the consumer boom in pretty spectacular fashion. There is an uncomfortably familiar ring about the conjuncture of high consumer indebtedness and international uncertainties. But in looking at the UK economy today there are also very clear differences – especially in terms of the inflation rate and the scope for policy action.

How severe are the UK's present imbalances?

Turning back to our present situation, how serious are the imbalances, and to what extent are they likely to constrain policy?

There are two main ways in which the present situation is quite different. I have already commented that today's imbalances, in terms of the four key sectors, are considerably smaller than in the late 1980s. And just in passing, note that the contrast between manufacturing and services is not dramatically wider than has been typical over the past thirty years. Over the period 1970 to 1997, the manufacturing output has grown by an annual average of 0.8%, and private services by 3.1%. In the 1997-2000 period, these growth rates were 1.0% and 4.2%. So manufacturing as a whole is still expanding at its rather sluggish historical rate, while the service sector is managing a somewhat better performance.

Secondly, the economy as a whole is not so far out of balance. References to any kind of output gap concept tend to make me feel uneasy – but with the benefit of hindsight, we now believe that the UK economy was a long way, as much as 5%, above its sustainable trend in the 1988-89. At the time this was not the prevailing view. Hard as it is to talk about output gaps for the past, it is very risky to do it for the present. However, looking at a combination of estimates published by the OECD, survey data and, perhaps most directly looking at the evidence of upward pressure on inflation, it seems unlikely that the UK economy is significantly above trend in 2001. The changed approach to policy should help to avoid major, prolonged, deviations from trend. This implies that, at the whole economy level, only a moderate slowdown would bring the economy back to its sustainable path, and halt the gradual upward pressure on underlying inflation apparent during 2001.

If the imbalances are relatively small, and if the economy is not far above trend, is there reason to be concerned about the imbalances? These two facts are perhaps not entirely comforting – sectors can come under financial pressure without being a long way out of line, and the real trouble with the output gap is that it can only be properly estimated several years after the event. To look more closely at possible forthcoming problems, we need to turn to the four sectors individually.

The personal sector has seen a real roller-coaster ride during the past twenty years. In the early 1980s recession, fear about inflation eroding the value of savings was the main factor behind a rapid rise in the savings ratio and a significant household sector surplus. However, as discussed above this situation had been entirely reversed by the end of the decade. Coming out of the 1991/92 recession, the household sector was seized by what at the time seemed to be over-caution, and ran a significant surplus until 1997 with the savings ratio staying at above 9%.

Two main explanations were offered to account for this sharp change of behaviour. One was a reluctance to take on high levels of mortgage debt, following the widespread experience of negative equity during the preceding recession. The other favourite was that individuals were much more concerned about job security, given both changes in the generosity of unemployment benefits, and some evidence that the length of time spent in each job had fallen sharply.

Rising levels of household debt in the recent past might be taken as suggesting that these explanations had now gone into reverse, with lower and more stable nominal interest rates and low unemployment bringing a sense of job security. However, a closer look at the underlying situation suggests that behaviour has not (or at least, not yet) repeated the enthusiasm for financial risk of 1998/89. Despite the recent rapid advance in house prices, they remain at a lower level, relative to earnings, than in the early 1970s or the late 1980s. In addition, the loan to income ratio has increased very little over the recent past, and low interest rates mean that income gearing, mortgage interest payments relative to income, remain modest by historical standards. Interest rates would need to more than double to take the entry costs into the housing market back to the distressed levels of 1989/90.

Averages, however, can obscure concerns about particular parts of the housing market. Data by region suggests, perhaps unsurprisingly, that in 2000 house price to income ratios in London were already well above their previous peak in 1989, and this is also true in Scotland. In London and the other high house price regions, the proportion of borrowers with high income gearing has also been rising rapidly. Similarly, first-time buyers house price to income ratio has risen faster than the average.

The effect of low inflation and low interest rates in reducing the problem of front-end loading, reducing the real burden of mortgage debt over the early years of the mortgage, suggests the possibility that borrowers have been shifting towards a new equilibrium at a higher debt/income ratio. Together with the low interest rates and the improved use of credit-scoring by lenders, this would be a reassuring factor, implying that recent housing market strength is unlikely to be followed by a housing slump on the scale of the early 1990s. Indeed, results from a standard house price equation would suggest that a probable outcome is simply that the rise in house prices will come to an end next year, rather than that there will be a sharp fall.

However, that conclusion is vulnerable to considerations about the nature of the downturn biting just at the moment, with the greatest negative impact on sectors concentrated in the South of the UK such as ICT, financial services and airlines. If consumer confidence does start to falter as the effects of these shocks are felt in the UK labour market, then there is a

risk that the housing market will prove more vulnerable, and that house prices will actually fall. At that point, other aspects of household finances could start to look more worrying, as unsecured lending to the personal sector is also at high levels.

While the present situation does not raise concerns about a rerun of the 1990s, as with low interest rates the financial situation is so unsustainable, there is nevertheless plenty of scope for retrenchment in the household sector. Very much slower growth in consumer spending is the first risk arising from the imbalances which the MPC has to bear in mind.

Turning to the corporate sector, similar considerations come to mind. Again, the overall situation looks reassuring when compared with the last recession. In both 1989 and 1990, the deficit for non-financial corporations stood at 4% of GDP, whereas in the second quarter of 2001 this deficit had reached only 1.3%. But again the details of the picture give more cause for concern. Work by the Bank indicates that there is a wide variation of financial situation, with the weakest 20% of companies having debt to profit ratios higher than at the time of the last two recessions.

The latest data from the Office of National Statistics for corporate profitability indicated that the disparity of performance is if anything getting worse. While service sector profitability has fallen back, it remains at levels which by historical standards are quite healthy. For manufacturing, however, there has been a sharp decline in the first half of 2001 to rates of profitability similar to the last recession.

A significant part of the corporate sector may prove vulnerable, because of the skewed nature of recent growth, to any forthcoming downturn. And if the focus is on the manufacturing sector, the reason for the vulnerability gives rise to even greater concern about what kind of shape this industry will be in to respond when the upturn arrives. In the late 1980s, the move into financial deficit reflected over-optimism in the manufacturing sector about future growth, and strong investment. This time around, it reflects the result of a long period in which sterling has been strong against the euro, keeping margins under pressure for many sectors and tending to inhibit investment plans. The picture is not of a sector which needs to adjust capacity down due to lower than expected growth, but rather of one which, due to sustained competitive pressure now has weak fundamentals in terms of investment levels.

The situation in the service sector has been very much more favourable, but the link between this weak manufacturing situation and the structure of the foreign deficit should be taken account of. It may not be inevitable that running a large foreign deficit will lead to a sudden period of adjustment, at least over the medium-term. But one way in which a foreign deficit is held to be unsustainable is that it enables unwarranted domestic demand growth in the short-term, which eventually will have to be corrected by a period of slower domestic growth as part of deficit reduction. This is less likely to be true if the deficit is related to the need to fund the purchase of foreign investment goods which would add to the supply potential of the economy.

In the UK's present situation, this is far from being the case. The deficit which has emerged since the late 1990s is more than explained by a widening deficit in traded goods, almost all of which is due to a deteriorating balance in finished manufactured goods, including a worsening balance on capital goods. The trade deficit, like the other deficits, has its roots in two causes: the inexplicably (at least, by economic models) strong sterling/euro exchange rate, and the relatively fast domestic demand growth in the UK.

The trade deficit, in the second quarter of 2001, was running at 2.2% of GDP, and a narrower current account deficit of 1.6%. This is not yet the size of deficit considered likely to trigger an exchange rate adjustment, though the trend is discouraging.

The public sector is the closest to balance of the four at present. However, looking ahead the position is projected to change, moving into a deficit of around 1.0% of GDP by 2003/04. The low net debt ratio, just 33% of GDP in the last full fiscal year, combined with the strong starting point, suggests that insofar as any sector can be described as being in a sustainable position, this one is. It would take several years of very low growth and associated tax revenue underruns to change the trends sufficiently for the debt ratio to rise to an uncomfortable level. Only if the output gap is being judged as wrongly as in the late 1980s is the public sector likely to hit constraints, even allowing for the cost of the present limited increase in military activity.

But the change in the public sector balance, if it proceeds according to plan, will have to be offset elsewhere, either through a yet higher trade deficit, or through a reduced deficit for the personal or corporate sectors. This has to be taken into account in considering potential adjustment scenarios for the UK.

The present situation could be summed up as resulting from a combination of a sustained over-valued exchange rate against the euro and a resurgence of confidence by households in their employment prospects. Some sectors of manufacturing are hollowing out, creating regional disparities, at the same time that personal consumption has been rising strongly. The corporate sector as a whole exhibits fortunes as disparate as do the regions.

To ask if the three sectors which are 'imbalanced' are in sustainable positions is really to run two questions together. One interpretation is whether or not the sectors could continue to behave in the same way indefinitely. Starting with the personal sector, it is of course true that debt levels cannot rise indefinitely. Debt levels now total around 120% of income, while wealth has already fallen significantly as a result of the decline in equity markets over the past year. With the housing market at best set to flatten out, the broadly declining trend in the savings ratio since the early 1990s is expected to be replaced by a rising trend to stabilise debt. This would certainly slow consumer spending, but a sharp adjustment as in the 1990s should not be necessary.

In the corporate sector too the rise in capital gearing and decline in profitability also suggest that many firms cannot continue to add to their financial deficit, and the widening of spreads seen since September 11 will increase pressure on those already starting to face financial constraints.

The external sector deficit looks less clearly as though it is about to adjust. It is very difficult to make an accurate assessment of the level of a country's external assets because of the use of historic valuations for direct investments. But the continued UK surplus in terms of interest, profit and dividends suggests that we are not yet in a net debtor position if overseas assets were valued on a more current basis.

It is the second question which raises the real difficulty for policymakers. Rather than a somewhat theoretical discussion about the sustainability of debt levels, the issue is whether the present imbalances are in practice likely to be sustained in a given set of circumstances, and what abrupt changes would mean for the course of the economy. While history suggests that imbalances can prove surprisingly long-lasting, and do not necessarily end in a disruptive adjustment, on the other hand, misjudgements can mean that an apparently sound situation changes rapidly into an unsound one (the UK fiscal position in the 1980s/90s). Equally, an adjustment can take place without being forced by credit constraints – households already in a strong financial position could become even more prudent under conditions of greater uncertainty. So defining the starting point by commenting on the size of imbalances does not provide policy makers with a simple road map.

What kind of adjustment might we anticipate?

If it were the case that the present imbalances were so wide that a correction was inevitable, there are a range of possible ways in which this might come about, and I will just describe some of these, before going on to look at the issue of the policy response.

Firstly, the rising corporate deficit could trigger a credit squeeze on that sector severe enough for firms to reduce employment, leading to a related adjustment of the personal sector as expectations about future income growth were adjusted down. Concern about offsetting such a development, which could also potentially have negative effects on longer-term supply prospects, might suggest easing of policy if the market for corporate credit seemed to be tightening.

Secondly, a completely different chain of causality, though with some of the same effects, might start in the external sector. Loss of confidence in the UK's ability to sustain the rate of growth necessary to attract continued financing of the widening trade deficit could trigger a sharp fall in sterling, a chain of events which is familiar not only from UK economic history, but also the experience of other major EU countries. Some of the debate about the UK economy today is reminiscent of the arguments about whether it was possible to sustain a faster rate of growth in just one major economy which characterised French macroeconomics during the early Mitterrand years.

With this development, the UK's growth rate might be forced to slow relative to the rest of the world by the adverse impact on real consumer incomes. The MPC would then be faced with the job of managing the inflationary impact of higher import prices, without forcing an abrupt adjustment on the consumer side. However, this task may not in practice prove as tricky as sometimes feared. There is evidence that importers into the UK have taken the opportunity provided by the strength of sterling to improve their margins in this market. As sterling declines they may well choose, especially against a background of weak global growth, to raise their prices by less in sterling terms than the scale of the devaluation.

One of the difficulties in assessing what course the UK may follow is that we are not alone in our potential problems. The US has an even larger current account deficit, relative to GDP, the level of US household savings has fallen and the corporate sector is also in deficit. The change to the fiscal plans since the tragedy of September 11 imply that the US public sector will move into deficit to offset an expected retrenchment certainly by households, and probably also by corporates. But, like the UK, the US is exposed by the large current account deficit to the risk that the rest of the world will be more reluctant to continue to acquire the offsetting dollar assets. A fall in the dollar, when the US domestic economy is already weakening, would put paid to any possibility of the US consumer continuing to play more than a bit part role in sustaining global growth.

So, thirdly falling sterling when the US is also adjusting would be less likely to lead to inflationary pressure as the market for traded goods and services would remain highly competitive with downward price pressure. There might be no need to raise interest rates, but from a monetary policy viewpoint simply to allow the adjustments in the economy, with some improvement of profitability likely for parts of the corporate sector and a narrowing external deficit.

Should monetary policy react to imbalances today

The above discussion does not exhaust the range of possible outcomes for the future of the UK's imbalances, in response to different shocks. In each of these the rising public sector deficit would need to be accommodated – probably through the adjustment of the personal sector. The range of scenarios suggests that it would be unwise to attempt to pre-judge or pre-empt the policy needed during possible adjustment. I have just suggested three different broad adjustment paths in which the policy reaction would respectively be to lower short-term interest rates, to raise them and to leave them unchanged. The MPC is charged with the task of looking forward, but this of course does not mean we would back one particular shock as being the most likely.

We do, however, have to take a view in our inflation report every quarter about a projection for the economy – and in arriving at this forecast the Committee is concerned to take a judgment about the balance of risks around that forecast. If all the most likely risks pointed to higher inflation that would be taken into account, and interest rates might be set a little higher than the base case forecast would warrant (and it goes without saying, given our commitment to symmetry that the converse would apply).

But in circumstances where there are offsetting risks, no impact on policy today is likely. And the tragedy in the US pointed up one good reason for not taking too much account of risks ahead of the event, but rather setting rates according to what is needed to keep inflation on track in the absence of future shocks. Had interest rates been raised, or kept higher, over the summer of 2001, due to anxiety about the growing trade and consumer imbalances leading to an inflationary fall in sterling, then when the actual shock of the terrorist attack occurred, the UK economy would have been less well placed to weather the ensuing storm. We would also have run the risk that higher rates could have exacerbated the original risk by pushing sterling up further.

The role of the subsidiary objective

Any discussion of the MPC's subsidiary objective, 'to support the economic policies of the Government, including its objective for employment' makes an MPC member feel uneasy. Rightly, we are all keen to stress that the inflation target has to be paramount. However, the existence of the subsidiary objective means we have to ask ourselves the question whether a particular approach to hitting the inflation target will introduce an unnecessary and undesirable volatility of economic growth.

It could be argued that, by permitting the imbalances to worsen rather than moving in the short-term to slow economic growth more than the inflation target alone would justify, we are increasing the probability that sooner or later the economy will be forced to experience a period of slower growth. This slower growth would occur primarily as the household sector adjusted its financial position, and private consumption was reined back.

It would be wrong to ignore this possibility. While monetary policy's prime goal is to give economic actors confidence in the long-term prospects for inflation, there has to be some allowance for short-term deviations from the inflation target to avoid unreasonable volatility in short-term output growth.

However, even the subsidiary objective does not point to an unambiguous conclusion in today's conditions. A key benefit of the existing regime is that the symmetric inflation target means policy makers are seeking to keep growth of the economy, overall, broadly in line with the growth of productive capacity. The additional confidence this potentially provides is, of course, limited by the fact that this clearly cannot be true for all sectors, and so individual firms will still face large cycles in their own economic fortunes. It will also be of rather less comfort if the growth of productive capacity itself is very slow.

In the very long-run, monetary policy is held to have no effect on the supply side of the economy. However, even without resorting to Keynes' famous remark, few of us are interested in the very long-run. We are, however, interested in the medium-term, where that is defined as the course of the next economic cycle. Over this period, the impact of monetary policy on short-run growth, and therefore on the expansion of the capital stock and on employment, is likely to have some effect because of the lags in adjustment of the supply side to changing demand conditions.

This means that undue economic volatility is not just undesirable at the time it is occurring, but may have effects over the course of the cycle if it triggers downward adjustment of the capital stock, or slower growth of employment and the consequent negative effects on skill acquisition.

In terms of the present policy considerations, there is a similar worry about the weakness of manufacturing investment over the past few years, and the potential for business sector investment overall to slow in the future. The MPC probably cannot today rein back consumer demand due to fears about the sustainability of consumer balance sheets, without exacerbating the problems of the business sector. As is so often the case, we have to balance risks against each other – the risk of having to handle a sharp consumer adjustment, against the risk of impairing supply side developments over the next cycle.

Conclusions

In the above discussion, I have distinguished first between imbalances which might be of concern for monetary policy makers, and others which should be tackled by government agencies responsible for delivering microeconomic policies, either nationally or regionally. Indeed, some imbalances which are commonly commented on (the divergence between the manufacturing and service sectors, for example) are not imbalances at all, but merely long-established differences of performance which sometimes proceed at a faster rate than others. This may or may not be desirable in terms of the development of the UK's supply-side, but does not necessarily pose any special problems for monetary policy.

I have also set out a number of arguments to demonstrate why it would be wrong to argue that policy should not be set in a way which worsens imbalances. The present imbalance between consumer demand and industrial production is rather a deliberate result of policy to sustain growth. It is far from clear that all periods of economic imbalance necessarily end in tears, although of course it is true that imbalances cannot go on simply getting larger and larger. But there are underlying fundamentals which will eventually drive that correction, and attempting to pre-empt this by policy action suggests that the policy makers have a high degree of certainty about where the imbalances ought to be at any point in time. The clear relevance of imbalances, as indeed of any trends in the economy, is what they suggest about the future path of the economy, and therefore of inflation.

If that is right, all that commentators mean when they say that imbalances create problems for the MPC is that they make forecasting more difficult. In my experience forecasting is always very difficult, and is not especially harder just because there are imbalances. What does make forecasting much harder, are uncertainties about political developments, such as are faced at the present time.

In summary, my view is that some of the rhetoric about imbalances is based on the idea that the economy is like a ball balanced on top of a pyramid, which will inevitably topple off if it moves too far in one direction. But my view is that it is more like a bicycle, on which the rider is always being thrown off balance by bumps in the road or sharp corners – but often manages to correct quite big shocks and only occasionally falls off. In that limited sense I am optimistic about the present situation in the UK. I am not convinced that the imbalances are so large, and so unlikely to self-correct, that we are about to fall off the bike.

More immediately, I am concerned by the set of headwinds formed by the weak global background and the strength of sterling. In the short-term, our best efforts may not be able to maintain the speed of the bike, but there is every chance that combined with policy easing elsewhere they will bear fruit in bringing about a recovery. Policy-making today, as ever, is not about targeting imbalances, but how best to set interest rates in the short-term to keep inflation on track over the medium-term.