BANK OF ENGLAND

Speech

Speech given by

The Rt Hon Sir Edward George, Governor of the Bank of England

At the Royal Society for the encouragement of Arts, Manufactures and Commerce (RSA), Birmingham

11 April 2002

I've had a long-time interest in the RSA. I was honoured to be elected as a fellow in 1986. But this is the first time I've participated in one of your programmes.

The Society, unusually, brings together people from different backgrounds and disciplines – across the arts to the sciences, but with a common interest in social and economic progress in the broadest sense. That diversity, but also commonality, of interest is reflected in the RSA Journal, which I find a fascinating read – whenever I get the time. It's reflected, too, in your lecture program so that I find myself slotted in between a lecture entitled "The feel good factor", on a medical theme, and another entitled "Chaos is good for you!" describing a creative approach to business management!

In fact I have been invited to talk about the "Monetary Challenges" we are currently facing – and, when you've heard what I have to say, you may feel that this juxtapositioning is not wholly inappropriate.

But let me begin by explaining what it is that we are trying to do through monetary policy at the Bank of England, and why.

For much of the first half of my 40-year career at the Bank of England, the emphasis of macro-economic policy as a whole was on short-term demand management designed to manage the perceived trade-off between growth and employment, on the one hand, and inflation and a manageable balance of payments position, on the other. Monetary policy was used in conjunction with fiscal policy and supported with various forms of direct control to pump up demand, when the economy declined and unemployment rose, until inflation and the balance of payments threatened to get out of hand, at which point all the policy levers were thrown into reverse. It was a recipe for short-termism throughout our economy.

We gradually learned from experience – perhaps more slowly in this country than some others – that there is no trade-off between growth and stability in the medium and longer term, and that, in managing demand – which of course we continue to do – we needed to pay far more attention to the underlying, supply-side, capacity of the economy to meet that demand. We came to recognise that direct controls merely addressed the symptoms of instability rather than its causes. We realised increasingly that fiscal policy was not well suited to the task of short-term demand management, and needed to be constrained within prudent limits if debt levels were to be sustainable in the medium- and longer-term. And this left a more distinctive and clearly defined role for monetary policy as the primary instrument for maintaining broad balance consistently over time between aggregate demand and underlying supply.

All this has become the accepted wisdom just about everywhere.

Since 1992 in this country the explicit objective of monetary policy has been to achieve stability defined in terms of a target for retail price inflation. And since 1997 the Bank of England – through the Monetary Policy Committee – has been delegated responsibility for setting short-term interest rates with the consistent aim of hitting the

Government's symmetrical 2½% inflation target (on a precisely defined measure of retail price inflation – RPIX).

Now the reason we've been set that task is not – as some people imagine – because either we or the Government think that consistently low inflation is the be all and end all of economic life. It is because we learned from our earlier experience that consistently low inflation is a necessary (though not in itself a sufficient) condition for the sustained growth of output of the economy as a whole, for high levels of employment, and for rising living standards, which are more fundamentally the things that we are all seeking to achieve.

"Stability is a necessary condition for sustainable growth" has become the universal central-banking credo.

So our objective – and the reasons for it – could not be clearer. But meeting that objective is not as straightforward as it may sound. The reason, of course, is that there is no simple, direct, link between our essential instrument – the short-term interest rate – and our objective, the rate of inflation.

Interest rates essentially affect the demand side of the economy. They do not directly influence the supply side, which depends upon a whole host of structural characteristics of the economy which are largely beyond the direct reach of monetary policy. What we have to do in managing short-term interest rates is to keep overall demand growing broadly in line with the underlying – sustainable – supply-side capacity of the economy as a whole to meet that demand. In other words we are trying to maintain overall, macro-economic, stability in a much broader sense, in the medium- and longer- and not just the short-term; and the Government's inflation target is the criterion against which our success, or otherwise, in achieving that broader macro-economic stability is to be measured.

Our problem is that we don't know with any great precision or confidence exactly what is happening on the supply-side – that's to say precisely what rate of growth we can hope to sustain. We don't know precisely either what is currently happening, or what is likely to happen, looking forward over the next couple of years or so, to overall, aggregate, demand. And we don't know precisely what the full impact of a change in interest rates will be on aggregate demand, or how long it will take before that full impact is felt.

Ours is not a precise science. In fact it's more of an art than a science. And, although we bring as much economic and statistical science to bear as we can, we know that our forecasts, and indeed our policy judgements, are subject to a range of error. They cannot be accurate to every last digit. We can't expect to hit the target all the time, but by consistently aiming to do so (and we do consistently aim to do so looking 2 years or so ahead) we can hope to get reasonably close to the target on average over time.

I'll come back in a moment to the objective, and to our experience measured against it. But perhaps I might digress briefly to make a couple of points about the principle of delegation of operational responsibility for monetary policy to the Bank.

Some people I know had misgivings about that when it was introduced in 1997 on the grounds that interest rates are intrinsically a matter for elected politicians. But that neglects the fact that within the present framework in this country the Government specifies the objective of policy. That is a political decision insofar as there may be a short-run trade-off between growth and inflation – and the Government delegates only the technical task of setting interest rates to achieve that objective to the Bank. I'm bound to say I welcome that distinction because the fact that the Government sets the target for monetary policy means that it is unambiguously committed to what we are tasked to do, and that, in turn, helps in some degree to distance the Bank from political debate.

But there are two necessary consequences of this arrangement.

The first is that you need independent, technical, experts to do the technical job entrusted to the MPC – not people appointed for their political convictions, nor representatives of particular economic or social interests. In that respect I think we have been extremely well served: the members of the Committee have been invariably well qualified for the technical jobs they've had to do; but more than that they have typically known enough, including about the inevitable uncertainties I have referred to, to know when they could be reasonably confident in their views and when they were guessing – as we all have to do at the margin. The Committee has been divided, generally very narrowly divided, in its forecasts and policy judgements more often than not since we started. That is both natural and healthy. But what is important is that the debate has typically been measured and reflective – and remarkably free of acrimony and dogma. And that to my mind is fundamental to the strength of the process.

The second corollary is that the MPC process should be transparent and that its members should be individually and collectively publicly accountable for their decisions. Transparency is assured by the publication of detailed minutes of our monthly meetings just two weeks after the event, and by the publication of our quarterly inflation report. These publications, and the continuous stream of speeches and interviews all around the country by members of the MPC, ensure broad accountability to the public at large. We see this as very much in our own interest, as monetary policy is likely to be more readily accepted – and more effective – if people generally understand what it is we are doing and why. But, beyond this, we publish each individual MPC member's voting decision each month – which they can then be expected to explain. Our procedures (though not our decisions) are regularly reviewed by the Bank's Court of Directors, and reported on to Parliament through the Bank's Annual Report. We regularly appear before the Treasury Select Committee of the House of Commons and the Economic Affairs Committee of the House of Lords. And, as Chairman of the MPC, I am required to write an open letter to the Chancellor if inflation strays by more than 1% either side of the 2½% target, explaining why inflation was adrift, how long the divergence might last, and the action we propose to take to bring it back on course.

So far as I am aware, taken as a whole, these arrangements provide far greater transparency of, and greater accountability for, the monetary policy process than anywhere else in the world.

But let me revert to my main theme of the monetary-policy objective and our performance against it.

Since an inflation target was first adopted in October 1992, inflation on the target measure has averaged just 2.6% – and has been more stable than at any time in our history. Since 1997 when the present target – and accompanying regime – was introduced, inflation has averaged 2.4% against the 2½% target. And, on the latest reading RPIX inflation was 2.2% in the year to February.

Now some people have suggested that, because inflation has recently been fairly consistently below target – albeit marginally below, by less than ½% on average over the past two years – monetary policy has been unnecessarily restrictive over this period. They've even suggested that we are not behaving 'symmetrically' – aiming to avoid an undershoot, below 2½% as determinedly as we aim to avoid an overshoot, which is of course what we are tasked to do.

Well, of course, hindsight is a wonderful thing!

Quite frankly I am amazed that we've been as consistently close to the inflation target as we have, and I'm astonished that I have not – or not yet at least – had to write an open letter to the Chancellor. Quite apart from the more general uncertainties, there have inevitably been a series of surprises (or "shocks" in the jargon) – including a persistently stronger than expected exchange rate against the euro, pronounced swings in the oil price, or varying rates of increase in excise duties, for example, any of which can have a significant and persistent impact on the out turn. That's not a matter of self-justification – it may well be more by luck than judgement; to be honest I'm more interested in the result. But I am concerned that people should understand that operating monetary policy is an inevitably imprecise process, and that they should not expect from it more than it can deliver.

But however that may be, the even better news is that since 1992, stable, low, inflation has been accompanied by steadily increasing overall output and employment, and by a progressive fall in the rate of unemployment.

Over the same period, to the fourth quarter of last year, GDP growth averaged just under 3% a year – which is well above most estimates of our trend rate of 2¼%-2½%. GDP had in fact grown for 37 successive quarters which is the longest period of sustained quarter-by-quarter growth we have enjoyed since quarterly records began in the UK in 1955.

Employment has increased steadily from a low point of 25½ mn people in the Spring of 1993 to its current level of 28 mn. And the rate of unemployment fell from a peak of over 10½% on the LFS measure to around 5% last summer; on the claimant count measure it fell from some 10% to just over 3%, which meant that the number of people claiming unemployment benefit, at under 950,000, was the lowest for 26 years.

Short-term interest rates are at a 38-year low.

All of that it seems to me gives the lie to a view that was quite widespread a decade ago, that sustained low inflation would inevitably mean continuous suppression of the real economy. I'd go further myself and suggest that it provides considerable positive support for the central bankers' credo.

Now some of you – given what's been happening to your own businesses, to certain particular business sectors, and in regions of the country where those sectors are particularly heavily concentrated – may think that I've been living on a different planet. The problem is – and it is a real problem – that with the best will in the world macro-economic stability, the stability of the economy as a whole, cannot guarantee stability at the more micro-economic level: it can not guarantee the prosperity of every individual business or even of whole business sectors or geographic regions. Once you look beneath the apparently benign surface of the economy as a whole in recent years, you find very substantial differences in particular between many internationally-exposed sectors of the economy – including particularly many manufacturing businesses – which have recently been having a really tough time, and other businesses largely serving our domestic market which have been doing pretty well.

Let me assure you that the MPC is only too well aware of the problem. We receive regular monthly written reports from the Bank's 12 regional agencies all around the country on the state of the economy as seen through the eyes of their 8000 or so business contacts. That includes reports from John Bartlett our Agent here in Birmingham and Chris Brown, our Agent for the East Midlands based in Nottingham, both of whom will be known to many of you. And about half the Agencies by rotation attend our monthly pre-MPC meeting in London to brief us face to face. Beyond that each individual MPC member makes regular visits to businesses located all over the country to see and hear for themselves. All of this plays a vital role in informing our interpretation of the bare economic and financial statistics. It's not that we do not know what's happening at the micro-economic level, the question is what can we – what should we – do about it in setting monetary policy?

It has to be said at the outset that some of the pressures businesses are facing are the result of long-run structural change affecting the global economy. The spread of international free trade under the auspices of the WTO is undoubtedly a positive development for all of us at the macro-economic level, but it is an added challenge to existing producers at the micro-economic level, and this country is not alone in re-sourcing supplies to some of the transition economies in Eastern Europe or to emerging markets in Asia and elsewhere. Nor can we – or should we seek to – avoid the impact of technological change.

But there are two main reasons for the particular pressures recently affecting the internationally – exposed sectors of our economy: the synchronised economic slow down over the past year or so in all major industrial countries, on the one hand; and the puzzling and persistent weakness of the euro in foreign exchange markets not just against sterling but even more against the dollar, on the other.

It is a striking fact that world trade in goods, which has grown at an average rate of around 7% since 1990, and grew by over 12% in the year 2000 alone, hardly grew at all last year! What that has meant for the UK manufacturing sector is that output in the year to January (the latest month for which we have internationally comparable data) fell by around 6%, and employment in manufacturing fell by 165,000 people, or by some 4%. (I'm delighted to note, however, that manufacturing output picked up modestly in February – the first monthly increased since August.) For what it's worth, we were not alone in experiencing the earlier decline. Comparable figures show that manufacturing output fell by over 11% in Japan, and by close to 5% in both the US and Germany, while manufacturing employment fell by 6½% in Japan and 7½% in the US – that's to say by more than in this country – although it fell by less than 2% in Germany.

The frustrating thing is that, with the best will in the world, there was not much that either we at the Bank, or the UK Government, could have done to ward off the pressures on UK manufacturing, which had their origins abroad.

That's fairly obvious where we are talking about the global slowdown – with negative overall growth last year of about 2% in Japan (fourth quarter on a year earlier) and close to zero growth in the US and Germany. This compared with growth of just over 1½% in this country – by some margin the highest in G7. We can go to international meetings and encourage the respective authorities there to stimulate their economies, but there is nothing that we can do about it directly ourselves.

What we were able to do – given that inflation was marginally below target – was to try to compensate for that external weakness by stimulating domestic demand here in the UK. The Bank sought to do this by cutting interest rates to buoy up consumer spending. And the Government stepped up its own spending, which was helpful given the international environment. Although we couldn't avoid an overall slowdown altogether – the economy on the latest data ground to a halt in the fourth quarter of last year – we have managed for most of the time to keep the UK economy as a whole moving forward despite the recession in the internationally-exposed sectors of manufacturing.

Of course we'd all have been much happier with better balanced growth. Stimulating domestic demand to offset the external weakness – the only option available to us – was very much a second best option. It was not without its own risks including the build-up of household debt and the current exuberance in the housing market. But it was better than doing nothing at all. That would have meant a much sharper slowdown, and probably recession, in the economy as a whole. And, given that inflation was well under control, it would have meant a quite unnecessary loss of overall output – and income and employment. In effect we took the view that unbalanced growth was better than no growth.

It is perhaps less obvious that we could not have done more to weaken the exchange rate. At around $1.40 – 1.50, sterling's value against the dollar through this period was not seen by most people even in the internationally – exposed sectors as a particular problem. The problem – for businesses trading or competing with firms in the eurozone, our largest trading partner, was the persistent and puzzling weakness of the euro. Now many people think that we could have caused the pound to fall against the euro simply by cutting our interest rate somewhat further relative to the interest rate in the eurozone. But it really isn't as simple as that. The US has reduced its interest rate far more aggressively than the ECB over the past year or so, and to well below the ECB's rate (to 1.75% as against 3.25%) but the dollar is actually stronger today against the euro than it was at the start of last year. And the same is true, though to a lesser degree of ourselves: UK interest rates were reduced by 2% from the beginning of 2001 compared with a fall of 1½% in the eurozone, yet sterling is stronger against the euro (though weaker against the dollar) than it was to begin with.

I don't think I can offer you a wholly convincing explanation for the euro's weakness since its introduction. It seems to have been driven by capital flows reflecting expected medium- and longer-term future corporate earnings growth rather than short-term interest rate differentials, and it is often suggested that these expectations reflect perceived supply-side rigidities within the eurozone. But whatever the explanation the resulting strength of sterling against the euro has contributed to the pressure on the internationally – exposed sectors of our economy, and a stronger euro would, from my perspective, help us towards better balanced growth in this country. It would also incidentally facilitate debate about sterling's possible entry into the single currency, in the sense that the undoubted attraction of nominal exchange rate certainty vis à vis our European trading partners, which is a major potential advantage of our adopting the euro, must depend to some degree on the likely exchange rate at which we might join.

These then are the monetary challenges that we have faced over the recent period.

The question now, of course, is where do we go from here?

There has recently been encouraging evidence – in the US data particularly but also for example in many of the more forward-looking indicators of European economic activity – that we are now in the early stages of global recovery. We cannot be sure that the early momentum will be maintained; nor do we know just how strong the expansion will prove to be or how long it will last; but the signs are promising, and indeed far more positive than any of us would have dared to hope just six months or so ago in the aftermath of the terrorist attacks on New York and Washington.

As it becomes clearer that the international environment really is improving, and that we really are seeing a sustained pick up in external demand, then we can look forward to better balanced and generally stronger growth in our own economy.

That will in due course mean that domestic demand growth – and consumer demand growth in particular – will need to moderate if we are to avoid a build up of inflationary pressure. It's quite possible, even still quite likely, that the necessary moderation of consumer demand – and I emphasise the word moderation – will come about of its own accord.

And that would be the best possible outcome for our own economy. But if consumer spending were not in due course to moderate of its own accord, and depending on the timing and the strength of the recovery abroad, we would clearly need at some point to consider raising interest rates to bring that moderation about.

But for the time being, and whatever the precise numbers, the overall prospect for the British economy over the next couple of years is for output growth picking up to around trend and inflation to around target. And if that is indeed how things turn out, we will have weathered the international storm as well as anyone could reasonably have expected.