BANK OF ENGLAND

Speech

Monetary Policy – A Perpetual Dilemma?

Speech given by

Kate Barker, Member of the Monetary Policy Committee, Bank of England

To the Charities Consortium, London

14 October 2002

I am extremely grateful to Rebecca Driver, Marilyne Tolle, Nick Davey, Stuart Lee and Kenny Turnbull for assistance and useful discussions in the course of the preparation of this paper. I also thank Marian Bell and Stephen Nickell for their useful comments. The views expressed here are personal and should not be interpreted as those of the Bank of England or other members of the Monetary Policy Committee.

Monetary Policy – A Perpetual Dilemma?

October 14, 2002

Introduction and overview

On the whole, the governed are suspicious and cynical when politicians tell them what a success one of their policies is. The 1997 reform of UK monetary policy, which established the Monetary Policy Committee at the Bank of England and gave it the power to set interest rates, is frequently claimed by the present Chancellor, and other members of the Government, as a major success story. More remarkably, it is generally referred to as a success throughout the media, the business community and (according to the regular surveys conducted by the Bank) has a pretty high approval rating from the public. The reasons for this are obvious –in terms of attaining the inflation target the MPC has kept inflation (just!) from straying more than 1 percentage point either side of the 2.5% target over the succeeding five plus years. Indeed, for 48 of the 63 months of the MPC's existence RPIX inflation has been within half a percentage point either side of the target. And it is a source of satisfaction that over the same period growth in the UK economy has averaged 2.6% and the rate of unemployment, on the ILO definition, has declined pretty steadily from 7.2% to 5.1%.

Despite this strong record, setting UK interest rates is not a job which allows room for complacency. We focus each month on future performance with its inevitable uncertainties. In addition, past history suggests it is highly likely that at some point the MPC will be faced by a large external shock (for example a big sharp swing in the oil price, or the sterling exchange rate) which will take inflation rather further from target than we have been so far. I have in mind here something rather more significant in its effect than the combination of generally rather erratic factors which took the June inflation rate this year down to 1.5%. This brought us within 0.1 percentage points of the inflation rate at which the Governor would have had to write to the Chancellor to explain why we were so far from target, and how and when our policy was expected to return inflation to target. But the fact the rate of RPIX inflation moved back to 2.0% in July indicated just how transient these factors were, whereas in the event of a large shock the impact would be rather more enduring.

Outside commentators tend to raise rather different concerns, and I want to respond to two of these. The first is a line of attack which is less widespread than it used to be, but still curiously persistent. It is that the present framework (or the way in which the present MPC operates the framework) is not sufficiently sensitive to the needs of manufacturing. The second, a more recent line of critique, is that the MPC should be more responsive to changes in asset prices. Both of these issues are expressed in a variety of ways (some rather better founded than others). Both stem from the same basic source, which could be characterised (with a little exaggeration in some cases) as the mistaken belief that monetary policy can solve more problems than just the delivery of low inflation, but that MPC members are too foolish, or too uncaring, to bother about doing so. Unsurprisingly, I believe that we are neither, and that it is up to us to continue not just to spell out successes, but also to be clear about what monetary policy cannot achieve.

In this context, I will look at:

- What has happened to the broad sectors of the UK economy and how that compares with other industrialised countries,
- How far monetary policy is likely to have affected this and whether there was some alternative policy which would have been better for manufacturing (or at least, better for the traded sector)
- Whether there is any reason for the MPC to be particularly concerned about developments in one sector
- The present outlook for the economy, and what that may imply for these broad sectoral trends
- Risks around the outlook due to asset price movements, how these affect our decisions and whether an alternative approach could improve economic management.

I will conclude with one or two more general comments about ways in which the UK's monetary policy framework seems to be misunderstood.

UK sectoral developments since 1997 – a cause of concern?

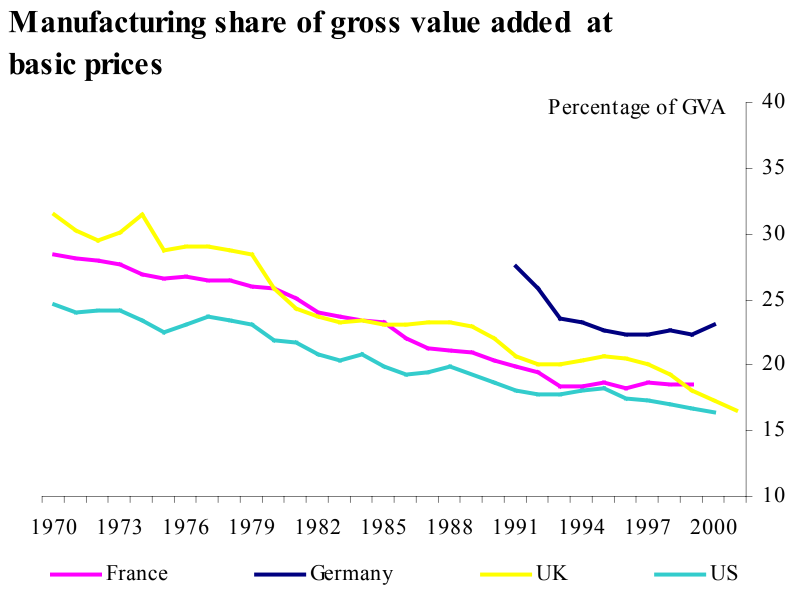
References to the divergence in fortunes between the UK's manufacturing and services sectors abound, and usually imply that this is undesirable. Whether or not it is desirable, this divergence is of course actually a very long established feature of the UK economy. It has certainly been more acute over the past five years – as services have been growing at an annual rate of 3.6% since the second quarter of 1997, above the average growth rate of 2.5% since 1970. Manufacturing, on the other hand, has actually contracted, by over 0.7% a year over the recent past, compared to the rather sluggish growth of 0.8% from 1970 to 1997. The recent pattern is unusual – since previous manufacturing recessions coincided with periods of restrictive policies and whole economy recession. It has provoked criticism that the stability at the level of the whole economy has been achieved only at the cost of poor outcomes for particular regions, or particular sectors. In terms of regions, the fact that unemployment has been falling in all regions of the UK is however rather encouraging.

Over the five years since the MPC was established, it has become more widely understood that it is simply not possible to set a single interest rate which will suit all regions and all sectors. However, there is still a lingering sense that in setting interest rates the MPC ought to have regard to the fortunes of the manufacturing sector in particular, and sometimes a suggestion in commentaries on our decisions that this is in fact what we do. In the spring of this year, for example, I read several times the suggestion that the MPC would not raise rates from 4% until the manufacturing sector showed clear signs of recovery. And following the decision in August to leave interest rates at 4%, the TUC commented: 'The Bank must be ready to cut interest rates next month to stabilise the economy and support manufacturing'.

The key reason for resisting this line of attack on policy is that in the long-run the new regime with low and stable inflation and less volatile growth will benefit the whole economy, even if in the short-run it will not be right for everyone – and this should always hold true. However, for the recent period I believe a stronger case can be made, which is that even under a slightly different regime of the kind which is sometimes suggested by others (with greater emphasis on growth, or a less rigid inflation target) it seems unlikely that monetary policy alone could have produced a better outturn for UK manufacturing.

It is certainly the case that UK manufacturing has performed relatively badly over the past five years (though all comparisons and trends need to be regarded cautiously as outsourcing and structural change means that the definition of manufacturing itself is becoming less clear and less useful. This of course means that the whole argument about sectors needs to be taken with a pinch of salt). Comparing the UK with other major industrialised countries indicates that the relative decline of manufacturing in the UK was rather worse, from 1970 to 1997, and has certainly been more pronounced since 1997. In the UK manufacturing was over 31% of total value-added in 1970, but only 20% in 1997 and 16.5% in 2001. But in France, for example, the share fell from over 28% in 1970 to 18.6% in 1997 and was then stable up to 2000. In the US, manufacturing was just 24% of total value-added in 1970, declining steadily (although perhaps a little more gradually than in the other major industrialised economies) to around 18.5% by 1997 (Chart 1).

Chart 1



Not surprisingly a broadly similar picture is apparent with regard to the share of employment in manufacturing. The decline in the UK has been particularly sharp since 1997 – with a fall in the manufacturing employment share of 3.5 percentage points to around 16.5%; compared with a fall in share of only 11.5 percentage points over the preceding 25 years. The only similar abrupt fall in relative manufacturing employment among the other main industrialised countries was also in the UK, during a previous period of exchange rate strength between 1978 and 1984 (if the experience of the newly-unified Germany in the early 1990s is excluded).

Relative performance is only one way to look at the UK's recent past. The manufacturing sector here might appear to have performed badly because the service sector of the economy has done so well. But overall, UK growth since 1997 has averaged 2.6%, comparable with 2.4% in the eurozone, and worse than the 3.2% achieved in the US. Looking at UK manufacturing in absolute terms, from mid-1997 to mid-2002 manufacturing output fell by 3.8%**,** whereas in the US, Germany and France over the same period there was an expansion of between 11% and15%, even though in the US and Germany output began to decline has been declining quite sharply in the sector by the end of the period. For employment, in absolute terms, the average fall in numbers employed in manufacturing in the UK from 1970-98 is 120 thousand per annum, compared with 145 thousand per annum in the past three years, implying an increasing proportionate rate of loss of jobs.

There are two other indicators which could be used to assess the UK's manufacturing sector, and the consequences of rapid structural change in the economy. The first is the UK's external trade position. It is certainly the case that the balance of trade in manufacturing alone has deteriorated significantly, from a deficit of £7 billion in 1997 to around £26 billion in 2001. The second is manufacturing net rates of return, which have fallen from a peak of 11.9% in 1997 to 3.6% in 2001, lower than in any year since 1984. Data is not available on the same basis for the eurozone countries to assess the impact of the recent downturn in growth, but in fact in the US the fall in rates of return in 2001 was even more dramatic due in part to the collapse of the hi-tech sector [1].

Did monetary policy drive manufacturing weakness?

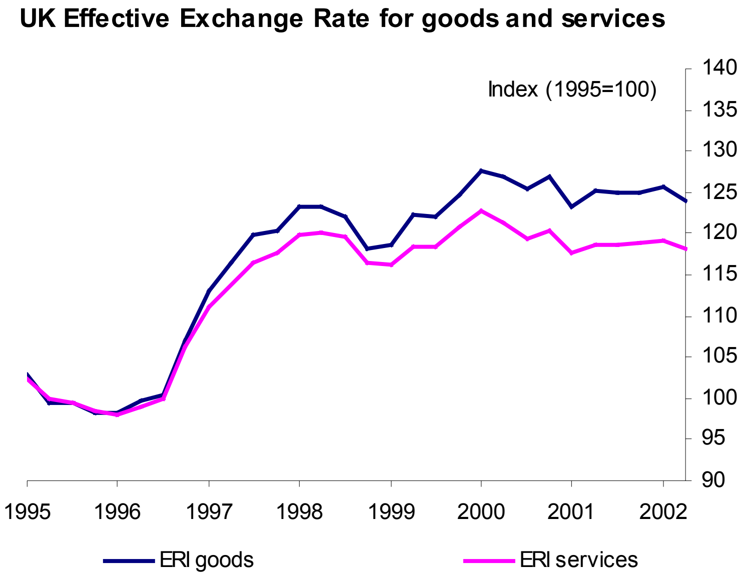
The comparisons given above suggest that to a large extent the recent weakness of manufacturing could be seen as in line with a long-established trend in the UK, which more broadly is part of the evident trend away from manufacturing among all the older industrialised countries. However, the pace of the structural change has been rather sharper than usual over the past 5 years, and followed on from a period in the mid-1990s in which UK manufacturing had seemed to be enjoying something of a renaissance. So it is not surprising that explanations for this experience have been sought.

Any shift in an established pattern is likely to be the result of more than one factor – but in this case there is a great temptation to point the finger of blame at the rapid rise in the sterling exchange rate, especially against European currencies, since the summer of 1996. There is however an alternative explanation, which would be a more encouraging story from the whole economy viewpoint. It is that the rate of return in services, and perhaps especially tradeable services, had been rising relative to manufacturing – attracting resources to move out of manufacturing. It is unfortunately difficult to disentangle rates of return on tradeable services from the service sectors as a whole, but evidence on service sector profitability overall does not seem to support this explanation as the source of the manufacturing decline. In the early-1990s, UK manufacturing rates of return improved sharply relative to those of the service sector.

So, to the extent that the recent poor performance of UK manufacturing requires special explanation, a story which runs from an unexpectedly strong exchange rate against the euro, to weak output growth, low productivity and poor profitability seems a broadly correct account. (It does however beg the question of why productivity growth in the UK was weaker than might have been expected even given falling output – especially following a robust trend in manufacturing investment in the mid-1990s, and in sharp contrast to US performance). This seems even more plausible as from late 1992 to 1996 the sterling exchange rate was widely regarded as being undervalued, and contributing to the period of good manufacturing performance. It is also worth noting that differences in geographic trading patterns between goods and services mean that the nominal effective exchange rate for services did not appreciate so much in the late 1990s as that for goods (Chart 2).

[1] International Comparisons of Company Profitability – L Citron and R Walton; Economic Trends ONS, October 2002

Chart 2



The main difficulty in answering the question about whether or not a different approach to monetary policy would have improved the fortunes of manufacturing is that of knowing the impact of any counterfactual on the exchange rate. Work at the Bank to try to explain why sterling has been so strong, and for such a protracted period, remains (unsurprisingly) inconclusive – but the conclusion reached in 1997 [2], that relative interest rates do not explain very much of the appreciation to that point, remains broadly true.

In order to explore the likely results of a different monetary policy over the past five years, the latest (August 2002) version of the Bank's macroeconomic model has been re-run from the second quarter of 1997, but with different monetary policy settings. The expected response of the exchange rate to a change in interest rates is assumed to occur, so that an increase in the interest rate causes the exchange rate to appreciate. However, uncertainty about this part of the transmission mechanism, (among other general difficulties inherent in re-running the past) mean that the discussion below is given only in indicative terms. It is also couched in terms of the external versus

[2] Decomposing exchange rate movements according to the uncovered interest rate parity condition – A Brigden, B Martin and C Salmon; Bank of England Quarterly Bulletin, November 1997

domestic sectors, as the Bank's model does not distinguish between manufacturing and services output.

A higher interest rate, of around half a point on average, over the past five years would have 'solved' one of the problems which have provoked some criticism. Even despite the appreciation of sterling, the impact on the current account would have been to reduce the size of the deficit, as lower demand in the domestic economy reduces the level of imports by more than the appreciation in sterling reduces exports. However, the cost of this better 'balance' between the tradeable and non-tradeable sectors would have been rather unattractive; a combination of lower growth (including probably less manufacturing output) and a significant miss of the inflation target on the downside. Against the actual global economic backdrop of recent years, an interest rate level held half a point higher would, towards the end of the period, have taken the inflation rate down to levels around 1%. In this case the risk of deflation would have started to appear a more serious concern.

But of course critics of policy from the standpoint of manufacturing are usually appealing for lower rates, and sometimes combine that with arguing that the inflation target is itself too rigid. Given that previous simulations (based around the Bank's May forecast) have suggested [3] that interest rates could have been a quarter point lower and the inflation target still met, was there some alternative policy setting which would have significantly improved the prospects for the external sector? The May simulations suggested that this modestly lower rate would have improved the volume of exports, though not very significantly, and of course the difference between the external and domestic sector would have worsened due to the boost to domestic demand.

In order to consider a more significant boost to the external sector a scenario with interest rates lower by one percentage point was considered. In this counterfactual, it is actually possible that the nominal exchange rate would have fallen more than expected by the model, not least as this would have implied the UK had adopted a higher inflation target (or allowed wider misses of the target). But on the basis that

[3] 'The MPC: Some Further Challenges" Sushil Wadhwani, NIESR, 16 May 2002.

the exchange rate did just move as the model expects, growth in the economy overall would have improved – but at the cost of a widening current account deficit as stronger domestic demand sucked in imports. A further likely implication of this scenario, not explicitly covered in the simulation, would have been higher long-term interest rates, due to a loss of policy credibility. This rise in the cost of borrowing due to loss of policy credibility would persist after the short-term boost to the economy from the policy shift was complete. So the gains would almost certainly have proved temporary and carried a risk of a high long-term cost – quite apart from the obvious consideration that at some point, probably within the five years, concerns over the risk of inflation volatility would have induced a policy tightening.

The above is of course just a long-winded way of restating the reasons for moving to an inflation target in the first place. While that target alone obviously does not guarantee steady growth for every sector at all times, nevertheless even for the broad sectors it is difficult to find alternative monetary policies which would have been clearly superior over the past few years. This is not intended to be Panglossian, as there might be some circumstances` in which this would not apply – though absent a major policy error it is not clear what these might be. And of course different sectors respond differently (in terms of both speed and size of output change) to interest rate changes,[4] a factor which is taken into account in policy discussions.

Is there a structural reason why the MPC should worry about the sectoral balance?

The terms of the Bank of England Act are pretty clear on what the MPC should worry about – which is the achievement of the inflation target. However, there is of course the subsidiary objective, which suggests that subject to achieving this target we are also charged to support the Government's growth and employment objectives. More specifically, this means that, especially if faced by a supply shock, the MPC does not have to get inflation back to target in a very short time period, if that is likely to cause undesirable volatility in the growth rate. But a second possible concern could be imagined, about whether the consequences of policy for sectors in the short-term were

[4] 'The Industrial Impact of Monetary Policy Shocks: Some Stylised Facts': J Ganley and C Salmon; Bank of England Working Paper No 68, 1997

likely to prove damaging to the UK economy longer-term by reducing the rate of growth of productive potential.

With regard to the present UK situation, there are two general strands to this argument. One is that the UK will not be able to finance a current account deficit at the present level indefinitely. Therefore that it will ultimately be corrected through a period of relatively slow growth, probably following a rising interest rate to choke off the inflation consequences of a significant fall in the exchange rate. But international experience does not suggest this is an inevitable consequence of a deficit of only around 2% of GDP [5].

The second line of argument put forward for policymakers (including but not exclusively of monetary policy) to give special consideration to manufacturing is the particular characteristics of the sector. It could be argued, for example, that circumstances where the exchange rate was out of line with the 'right value' for an extended period could result in a long-run weaker growth rate. This is contrary to the general result that the macroeconomic level monetary policy has no effect on potential output, which is determined by supply side factors. One reason for believing this might be true is that the sunk costs and long lead times associated with manufacturing investment mean there is a risk of hysteresis (or path dependence). Once manufacturing firms pull out of the UK, they may stay out even if the initial trigger (in this case the strong exchange rate) is reversed. This may be particularly true in the older industrialised countries, where the impact of a period of a strong exchange rate may be to accelerate what would otherwise have been a more extended, and perhaps less painful, period of structural change.
Another set of arguments relate to productivity, where it is true in that UK data indicates manufacturing has a higher level of labour productivity in terms of output per head, compared to services, and a higher growth rate of productivity. Recent estimates indicate that manufacturing labour productivity averaged 2.3% per annum for 1989-99, compared with 1.5% for market services [6]. But despite best efforts it is

[5] Current account adjustment in industrialised countries – C L Freund: International Finance Discussion Papers no 693, December 2000; Board of Governors of the Federal Reserve System
[6] Britain's relative productivity performance: Updates to 1999: M O'Mahony and W de Beer; National Institute of Economic and Social Research, March 2002

still difficult to be confident about the size of this gap, due in part to the familiar problems of measuring service sector output where both quantity and quality are hard to estimate. About 12.5% of GDP is in fact accounted for by private sector services for which productivity growth is assumed, rather than measured. And care also needs to be exercised in taking these numbers at face value – if part of the shift into services reflects outsourcing of low productivity activities from manufacturing companies, the resultant higher productivity growth in the manufacturing sector is a misleading guide. The example of the US, where the manufacturing sector is smaller than in the UK, but the level of overall productivity is higher, in any case suggests that manufacturing does not have to be a certain relative size to produce economic success.

In any case, the story of the UK labour market over the past five years is of falling manufacturing employment, more than offset by service sector job creation. At the same time the rate of overall labour productivity growth has slowed, but certainly not ground to a halt. As over the same period unemployment has fallen significantly, it is far from obvious that this is a story of economic weakness.

Is there, however, some form of external constraint on growth which does not simply relate to the problems of financing the current account deficit? Since 1996, CBI surveys indicate that the proportion of UK manufacturing firms investing to expand capacity has been on a declining trend. This might imply that export capacity has been lost, making it less likely that UK exports could recover as strongly, as global activity picks up, as past experience would suggest. Possible implication would include the early emergence of capacity constraints in the tradeable sector and some associated inflation pressure, with the rebalancing of the economy between the domestic and external sectors being delayed.

But this seems an unduly pessimistic expectation. Neither the CBI's Industrial trends Survey, nor the British Chambers of Commerce quarterly survey indicate that capacity in manufacturing is particularly tight. In addition, UK service sector trade has performed rather better since 1995, with little deterioration in the size of the services surplus, and might be expected to improve further into any global recovery.

So, it is difficult to construct a clear argument at the macroeconomic level that the balance of the economy over the past five years has been inimical to the UK's growth rate over the medium-term. And as argued above, even if that were a concern no viable alternative policy was available which would have produced a better result even for the traded sector. There may be other reasons to seek to arrest manufacturing decline, such as the need to retain research and development, or to develop valuable skills, but these apply to a subset of the sector and probably better aided by specific policies.

The present outlook and likely sector trends

Any observer of the UK economy who worried about divergent sectoral trends would have been frequently disappointed over the past few years. A whole sequence of forecasts emerged which projected a narrowing of the divergences, either based on an expected weakening of sterling, or on strong growth in the world economy. In the event, a series of factors (the Asian crisis, the hi-tech collapse, September 11, the accounting problems of US business) have created problems for the global economy. At the same time sterling has remained strong, mainly against the euro although latterly showing resilience against the dollar.

The Bank's May 2002 Inflation Report certainly described a future in which the UK's exporters would find life more comfortable – prefiguring a continued global upswing into the second half of the year. Subsequent events in the equity markets, reflecting further worse than expected corporate profits, and uncertainties over Iraq, have of course resulted at best in a delayed recovery of the world economy to trend growth.

One consequence is that our latest forecasts imply that the UK is set to continue to grow rather faster, relative to the rest of the world, than the average of the last 20 years. In these circumstances there will be continued reliance on domestic demand growth to maintain UK growth sufficient to keep inflation at the target, and a modest further deterioration of the current account deficit, implying the domestic/external divergence will remain.

The picture domestically of course will not look exactly the same as the recent past, as the sources of growth will differ. In particular there will be a shift towards public spending, linked with increased construction activity. But within the overall outlook, there are two issues which are trickier to predict and in different ways present problems for policy.

The more obvious of these is the consumer. It seems likely that the MPC will continue to find it challenging to manage the right pace of consumer demand. Neither the debt/asset ratio, nor the interest/income ratios of the personal sector have moved into uncharted territory. But the house price/earnings ratio is certainly considerably above its long-term trend, and the overall debt/income ratio has been rising steadily in recent years. In these circumstances, it is difficult to assess how the consumer's appetite for debt will change when interest rates are changed – in either direction. And an added uncertainty is how far concerns about the health of pension schemes and endowment policies, with implications for personal income often many years in the future, might affect demand today.

The prospects for business investment are also unclear. The level of investment peaked at the end of 2000, and has since fallen sharply, down almost 15% in manufacturing and 16% in services by the second quarter of 2002. In the service sector in particular the bulk of the decline has taken place since the third quarter of 2001, and so may in part reflect a period of hesitancy following September 11. In this case, a relatively sharp recovery might have been expected in the second half of this year, especially as rates of return in the service sector as a whole remain at high levels. But the fresh set of global concerns which has emerged over the summer, together with the pressures on much of the financial sector, suggest that the pickup may disappoint at least initially, raising doubts about the pace of recovery.

However, while there are some concerns about the UK economy it is important to set these into a historical context, and note that the overall outlook for the UK economy remains pretty bright. Compared with most of the previous twenty-five years, the long period of growth and declining unemployment which started in 1993 is remarkable as it has met no significant reversal. To be at the end of this long upswing without having encountered inflation pressures, and with the level of economic activity judged to be fairly close to trend offers a good prospect for the UK to weather any further international squalls, even though we may be sailing a little closer to the wind than over the recent past.

The discussion above suggests that the prospect of a some further period of imbalanced growth, with the external sector continuing to perform relatively badly, should not alter this conclusion significantly, as the external deficit even in these circumstances is projected to worsen only modestly. However the pace and pressures of structural change at the more micro level are unlikely to ease up.

Risks from Asset Prices

In the discussion above, I have implied that I do not believe it is possible to use monetary policy to manage the exchange rate, or even reliably alter it in a desired direction. But more generally the question of whether, and how, monetary policy should react to asset prices has recently taken over in popular debate from the issue of whether, and how, monetary policy should respond to sectoral divergences, and I wanted to comment also on this, though rather more briefly. The present UK situation offers another opportunity for commentators to describe the situation facing the MPC as a dilemma, with falling equity prices balanced by an unsustainable pace of house price increase. Meanwhile the exchange rate remains strong – but being relatively stable is attracting little attention.

In these circumstances, the view that central banks should respond only to the likely inflation impact of asset price movements as they stand, rather than become concerned with trying to move asset prices towards some judgement of sustainable levels, seems readily defensible. Indeed, given the apparent link in the UK between equity prices and housing at the moment with one type of investment substituting for the other, it would be a tricky judgement to determine how interest rates should be moved if the MPC did decide one of these markets should be a specific policy consideration.

But this argument does not fully meet the criticism that policy should take account of asset prices, which is being made with hindsight and refers to the period broadly around 2000 when the exchange rate and equity prices were both believed to be overvalued and the housing market was gathering strength. It remains my view, however, that unless there is clear evidence that demand in the economy as a whole is out of line with supply capacity in a way which would point to the same policy response (by in itself posing a risk to the inflation target), there are good arguments for not reacting to apparent asset price misalignments. This was not the situation that prevailed in around 2000.

Of the arguments against reacting to asset prices over and above their effect on inflation, the first, put forward recently by Chris Allsopp, is that any attempt to target asset prices would inevitably compromise the transparency and credibility of policy, eroding the benefits of the UK's new policy framework[7]. This is a very significant point in the UK context, where in the past considerable economic disruption has been produced by a failure to find a coherent approach to monetary policy, or to stick to one approach in the event that it created short-term problems.

The second is the equally familiar difficulty of recognising when a clear asset price bubble or unsustainable position is actually prevailing. To give two examples: the view prevalent in the late 1990s that sterling was overvalued in terms of the effective exchange rate (rather than simply against the weak euro) seems less easy to substantiate now that it has prevailed for so long. And in the equity market – although at present it seems to have been clearly overvalued in 1999/2000, it is still uncertain by how much. It is difficult today to distinguish whether the equity market has overshot on the downside due to concern over the possibility of war with Iraq, or has simply returned to its longer-term average P/E ratio – and conclusive answers to these questions are unlikely for several years.

The third is that in the event of a serious asset price overshoot, market sentiment is unlikely to be easy to turn around, meaning that a significant change in interest rates would be required to have the desired effect. Again to give an example, if equity prices were considered 'too strong', the necessary rise in interest rates is very likely to make more certain (and possibly more severe) the downturn which is the very risk the policy action was trying to avoid. This argument may well apply to the UK

[7] "Macroeconomic Policy Rules In Theory And In Practice" Christopher Allsopp, Cambridge University 19-20 September 2002.

housing market today, where rising prices result from a number of factors other than low interest rates.

Finally there is the question of whether it is the task of monetary policy to protect individuals from the consequences of irrational market judgements. It is of course the task of policymakers more generally to arrange the regulatory framework and ensure that individuals are appropriately protected against the negligence or wrongdoing of others. But within that framework it is unclear how far it is possible or desirable to remove further elements of risk, without the disadvantage of distorting market behaviour.

I would not go so far as to argue that it would *never* be right to take specific action aimed at correcting an asset price misalignment, even when that policy was not justifiable directly in terms of the inflation target. But the circumstances when it *is* right seem likely to be extremely rare.

Conclusion

The framework under which the MPC operates is set out very clearly in the Bank of England Act. Some of the criticism and commentary on the MPC's decisions reflects misunderstandings of this framework. For example, Committee members are individually responsible for their votes, and should therefore on every occasion vote for the outcome which they would really like to emerge from that meeting. In recent months, however, it has been suggested that it would have been better to have had one or two committee members voting for a cut, to give some indication of how near to cutting the whole Committee is (and earlier in the year much the same was said with regard to the possibility of a rise). But this would leave the individual unable to justify their vote adequately to the Treasury Select Committee (or come to that any other audience), and would make it difficult to explain future changes in voting.

But the bulk of recent criticism, the points which I have tried to address today, stems not so much from a misunderstanding of the framework, but from expecting too much of it. While the MPC is sometimes held to be indifferent to what is happening to manufacturing, the discussion above points out that, since we seek to manage the economy as a whole, we of course care about manufacturing, just as we do about every sector, in direct proportion to its importance in the economy. Similarly, we look at asset prices in the same kind of way, assessing the impact of changes in prices on the inflation rate. It would not be possible to direct our attention to specific sectors or asset prices without running other risks.

In that sense it is wrong to say monetary policy faces a dilemma because of sectoral divergences, or contrary movements in asset prices. We face a series of difficult judgements in balancing these factors – but since we are not attempting to impose on the world a particular growth rate for manufacturing, or level of equity prices, it is not a dilemma as we don't have to choose between the competing pressures. We just have to focus on the target which we are employed to meet. And in fact the experience of the last few years suggests that this broad approach to policy has enabled a rapid pace of structural change to occur, without knocking the economy as a whole badly off course.

I have read recently statements such as 'low and stable inflation is not enough' or 'central banks need to do more than just deliver low inflation'. The first seems to me to be true. Of course, in some sense low and stable inflation is not enough. It obviously does not remove all the risks inherent in running a business, or investing in a pension. But it does mitigate these risks to some extent by the implied focus on avoiding swings in the level of economic activity far away from the sustainable growth rate. The second, at least as far as monetary policy is concerned, seems to be largely wrong. Low and stable inflation may not be enough - but it is very much better than high and volatile inflation, or a bout of deflation. And we should not be seduced by the recent record of success into thinking that low and stable inflation is so easy to deliver that central banks can now deliver other things alongside it. Indeed, any attempt to do that would put the achievement of the inflation target at risk. Finally, and obviously, as I indicated at the beginning, 'just' delivering low and stable inflation actually remains a pretty tricky job.