

Eddie George: The case for sustained macroeconomic stability in the United Kingdom

Speech by the Rt Hon Eddie George, Governor of the Bank of England, at the British Chamber of Commerce National Conference, held in London, on 4 April 2000.

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Ladies and Gentlemen, they say that in the monetary policy business one of the key elements to success lies in getting your timing right. Well, I have to admit that the timing of my appearances at your national conferences has been less than perfect.

Central bankers are rarely popular with the business community when interest rates go up - even though I explain to them that rising interest rates are a reflection of a strong economy. Savers tend to be more understanding. They only complain when interest rates come down - even though I explain to them that that is a reflection of lower inflation which means that the value of their savings is being better maintained.

But, in any event, in the run-up to my first visit to your conference, in May 1995 in Aberdeen, we'd raised interest rates in successive steps, by 1½%. In those days of course I could blame the Chancellor! But I should point out that our next move, in December 1995, following the conference was to begin cutting rates - though I wouldn't suggest it was solely as a result of the conference. In the run-up to my second visit, in June 1998 in Birmingham, we had again put up interest rates in successive steps, by 1¾% - with no one else to blame. But once more, following the conference - and again I imply no direct cause and effect - our next move, in October 1998, was to begin cutting rates. And here I am, my third attempt, only to find we've done it yet again - in the run-up to this conference we have once more raised interest rates in successive steps - by 1%. I make no prediction as to what might happen following this conference - one way or the other!

Despite this unfortunate timing I'm very happy to be with you again this morning. My earlier experiences mean that I'm quite used to entering this particular lion's den - even on this occasion Roger Lyons' den! Good morning, Roger.

I well understand that some of you - perhaps many of you - would like interest rates to be lower, in the hope particularly that this would also lower sterling's exchange rate especially against the euro. And to be perfectly honest, if I were a farmer, or a steel maker, a motor manufacturer or even a hotel operator, indeed anyone competing primarily with Continental European producers right now, from my own, microeconomic, standpoint, I'd find that tempting too. Although the exchange rate, still less the level of interest rates, may not be the root cause of all our present sectoral, and related regional, pressures, there is no doubt that the exchange rate in particular is adding to the pain that some of you are going through.

So what then is my defence?

My first, and principal, witness, is the macroeconomic data - the data relating to the UK economy as a whole.

For the past seven years or so - starting well before the MPC came into existence - monetary policy has been directed specifically to achieving a low and stable rate of retail price inflation - the inflation target set by the Government. Low inflation is not simply an end in itself. Achieving it consistently involves keeping aggregate demand continuously broadly in line with the underlying supply-side capacity of the economy as a whole to meet that demand. So low inflation is in effect a measure of macroeconomic stability in a much broader sense - it, too, in fact is a "policy with a purpose", the purpose in this case being sustainable growth of output and all that that means for a high level of employment and rising living standards.

Since that policy was adopted some seven years ago we have in fact achieved the longest period of sustained low inflation we've known for a generation. Retail price inflation, on the Government's target measure, has averaged 2.7%.

But alongside low inflation we've had the lowest nominal interest rates that most of us can remember. Short-term rates have averaged some 6¼% compared with some 11¼% over the preceding decade. And 10-year government bond yields have fallen, with inflationary expectations, to around 5¼% which apart from a brief period last year is the lowest they've been for nearly 40 years.

Much more fundamentally we've enjoyed the longest period of uninterrupted, quarter by quarter, economic growth since records began some 45 years ago - with annual growth averaging 2.8% - between ¼ and ½% above most estimates of our underlying trend rate. The number of people in employment is the highest on record. And unemployment has fallen from a peak of 10½% on a claimant count basis to the present rate of 4%. That is the lowest for 20 years in the UK as a whole, and just about the lowest in nearly every region.

This is not just past history. Having come through the global economic slowdown a year or two ago, the economy as a whole is now again growing at well above trend, with inflation a bit below target; and the broad prospect for the next couple of years - on most forecasts, including the MPC's February forecast based upon our collective best assumptions - is for continuing relatively strong growth with relatively high employment and relatively low inflation. The policy debate for the time being remains - as I've said before - a comparatively narrow one about just how strong the growth, how high the level of employment and how low the rate of inflation.

In terms of the economy as a whole, I'm tempted to rest my case.

Our problem - and it is a real problem, as we have recognised for some time - is the imbalance, within the overall economy, between the domestically-oriented businesses and sectors, and those that are most internationally exposed. In part that imbalance is a hangover from the earlier global slowdown - though the welcome recovery in global demand means that this influence is now diminishing. The more important factor now is the persistent weakness of the euro - not exclusively against sterling but equally against the dollar and the yen. The impact is particularly severe on the UK because of the closer ties between our economy and that of the euro zone.

I've not heard a wholly convincing explanation for the euro's persistent weakness. Many analysts relate it to market concerns about structural rigidities in some parts of the euro zone, which are encouraging direct capital outflows attracted elsewhere by higher prospective earnings growth. Whatever the cause, few of those I talk to expect it to persist. But in the meantime, given that the problem is a general weakness of the euro rather than any particular strength of sterling, it is very difficult to see what we can do directly to resolve it.

The weak euro affects us at the macroeconomic level in two ways: it has a dampening effect on our price level; and it reduces net external demand on our economy. To offset these influences - to prevent overall demand growth falling short of underlying capacity growth, causing inflation to fall significantly below our 2½% target - and I remind you it is a symmetrical target - we have had to keep interest rates lower than would otherwise have been necessary, in effect encouraging stronger domestic demand growth, to keep the economy as a whole on track. The risk in this approach, of course, is that we could find it difficult to moderate the pace of domestic demand growth to a sustainable rate as and when the euro recovers. But that's a bridge we will need to cross when we get there.

Now some of you involved in those sectors that are suffering most from the weakness of the euro would - from your own perspective - like us to go further and try more actively to drive the exchange rate down. As I say, if I were in your shoes, I'd be tempted to argue that myself. Euphemistically it is suggested that we should "pay more attention to the exchange rate" - than, as I've explained, we do already. In practice what that would be likely to mean in our present situation is substantially lower interest rates: the intended effect would be to stimulate external demand, but it would inevitably also involve further stimulus to domestic demand. In effect, it implies that we should acquiesce in increasing overall demand pressure leading inevitably to faster inflation. That might conceivably even

provide some relief to the suffering sectors in the short term. But increasing demand pressure, including labour market pressure, and accelerating inflation would - as we've repeatedly seen in the past - ultimately need to be brought back under control, involving a more abrupt tightening of policy. That frankly would not do the suffering sectors themselves much good at least for very long - and it would have a potentially serious destabilising effect on the economy as a whole. That is precisely what we are trying to avoid.

And there, I do rest the case for the defence - at least in relation to the principal charge of malice aforethought - or even malice as an after thought. Just as some of you would like to see the euro strengthen from your microeconomic standpoint, so too would I, from a macroeconomic perspective, because it would help to restore a better, more sustainable, balance within the economy.

But I don't think that one can realistically argue that we should consciously put the economy as a whole at risk of excess demand pressure and accelerating inflation in order to try to bring about a weakening of sterling against the euro. Yet that in substance is what the witnesses for the prosecution would be asking us to do.

Now, even if you accept my case that macroeconomic stability, in the terms in which I've described it, is the right objective, there is nevertheless a more technical - but still serious - charge to answer.

Some of those who agree in principle nevertheless argue that we are simply exaggerating the macroeconomic risks. The charge in this case is that we don't in fact need interest rates at their present level, certainly not at any higher level, to maintain macroeconomic stability. That would be a technical judgement on which even the best informed experts might legitimately disagree: in fact as you may have noticed even the members of the Monetary Policy Committee themselves disagree, more often than not, at the margin.

Now is not the moment for me to launch into that technical debate - just a day before our monthly policymaking meeting. In fact, strictly speaking according to our MPC "purdah" rules I ought not to be here at all.

But you can find a detailed description of the technical debate, in the minutes of our policy meetings and in the Quarterly Inflation Report, either in our printed publications or on the Bank's website. We are among the most transparent central banks anywhere in the world. Our debate is informed by a huge input from our very able professional staff both in London and in our Agencies throughout the UK, and I'd frankly be surprised if you were able to identify any relevant issue that we have not considered in one way or another. Indeed I would very much hope that you would let me know if you did. I don't plead ignorance; I plead intrinsic uncertainty. Monetary policy operates with a lag, having its full effects only after about a couple of years. Unlike some outside commentators apparently we know we don't have a crystal ball. Our judgements are necessarily based upon a very careful assessment of the balance of risks at the time, continuously updated in the light of the constant flow of information of all kinds relevant to that assessment. That's the nature of the process.

Given that, I would not expect, and you would not reasonably expect me, to be able to demonstrate to you that we have precisely the "right" answer at any particular time. But I can promise that if the evidence changes in either direction so too will our assessments. You can of course question our processes, our interpretation of the data or the quality of our analysis - it's there for all to see. But ultimately the proof of the pudding is in the eating, and it is only on average and over time that our policy decisions can sensibly be judged.

I'd be surprised if those who question our technical judgement at any particular moment could offer more than that.

In the circumstances, I do not ask that the technical charge brought against us should be dismissed. But I would encourage you to suspend judgement, or at least to limit our sentence to an extended period of probation.

I'm ready now for the cross examination, before the jury begins its deliberations!