Ian Plenderleith: Monetary stability as a foundation for sustained growth

Speech by Ian Plenderleith, Executive Director of the Bank of England, to the National Association of Pension Funds Investment Conference held in Eastbourne on 14 March 2001.

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The UK economy has embarked on the new millennium with much the same healthy stride as marked its progress through the final years of the old.

Over the past year, we have seen the economy continue to achieve steady and sustainable growth. We are, indeed, now in the ninth year of continuous positive growth in output. This remarkable track record has brought with it a steady rise in employment, with the benefits being felt in high levels of job creation throughout the regions of the country; and unemployment has fallen to the lowest levels we have seen in decades. All of this has been achieved with inflation remaining low: the RPIX is currently running a little below our target of 2 1/2% and has averaged 2.4% pa over the nearly-four years since the MPC was given responsibility for managing interest rates. In the process, with inflationary expectations now anchored at low levels, 10-year bond yields have fallen to around 4 3/4%, as low as can be found in any industrialised country except Japan.

What is particularly encouraging about the past year is not just that we have been able to continue on the track of steady growth. More than that, developments during the year have helped in several ways to strengthen the prospect of our being able to sustain this improved economic performance going forward. A year ago, output was growing at over 3%, which is arguably faster than we can hope to sustain for any length of time without running risks of generating inflationary pressures. We needed therefore to see some degree of moderation in the pace of overall demand, to ensure that the economy could continue to grow without generating strains. For preference, the moderation needed to come principally in the area of consumption spending, which had been the major factor driving growth through last year, as households enjoyed the benefits of high employment and rising incomes. Sustainable growth in household spending is, of course, highly desirable and very much the mark of a healthy and growing economy; but it needed to be balanced against the equally desirable planned increases in government spending on public services, and the higher levels planned for public investment on improved infrastructure, both made possible by the government's strong fiscal position. The need was to ensure that all these sources of demand did not over-stretch the economy's overall productive capacity. The evidence that consumption spending may indeed have moderated somewhat towards the end of the year, and in parallel that there has been a resumption of growth in business investment, represents an improvement in the balance of demand in the economy which in turn improves the prospect of our being able to sustain growth going forward.

An improvement in the balance of the economy was also achieved last year from another source - a welcome easing in the strength of sterling which itself had been a reflection of the persistent weakness of the euro. As the euro has recovered somewhat over the past year, and sterling has moved back from its peak levels, this has, at least in degree, eased some of the pressures faced by exporters and by businesses most exposed to import competition. The result is a better balance between the externally-exposed sectors of the economy and domestically-orientated businesses, between manufacturing and services, and between different regions of the country.

Two other clouds that had threatened the sustainability of our growth performance also receded somewhat last year. One was the impact throughout the economy emanating from the steep rise in oil prices, which abated as oil prices fell back from their peak levels. The other concern was that share prices had risen to levels which many felt were not sustainable in terms of reasonable expectations of future corporate profits. The fall in share prices during last year was not a comfortable experience - falling asset prices rarely are - but it removed some of the sense of unreality. Of course, it is never easy to judge what levels of financial asset prices are realistic, and the risk of volatile adjustments remains, as we have seen in recent days, but the important point is that the downwards adjustment experienced last year, which could have been abrupt and might have generated wider economic effects, was in fact achieved without significant repercussions on the real economy. In both cases, the result is a better foundation for the prospects for sustaining growth in the economy.

Let me now turn from the year past to the year ahead. I have stressed the encouraging performance of the economy over the past year, and the confidence we can hopefully take in its underlying soundness, because we undoubtedly face serious challenges and a material increase in uncertainty in the year ahead. Most notably, we have to manage the UK economy against the background of an international environment in which the US economy has begun to experience a sharp slowdown.

Each quarter the Bank of England publishes an Inflation Report which sets out the MPC's considered view of the prospects for growth and inflation looking two years ahead. Let me start from our latest Inflation Report, published last month. That recognises that the weaker outlook in the US will depress global demand and dampen growth prospects in other countries. The UK cannot, of course, expect to be immune to this weakening process. Our central projection, on the basis that there are reasonable grounds to expect the US to return to moderate growth in the latter part of this year, is that the impact on the UK from the weakening of global activity should be moderate. But we judge that the risks are weighted on the downside, principally on the basis that the pause in US growth could be deeper or more prolonged than expected. Domestically, on our central projection we see reasons for domestic demand to remain fairly well sustained. Overall, therefore, our central projection is for some slowdown in UK growth, to around 2% in the latter half of this year, reflecting the deterioration in global prospects, but thereafter a recovery in growth to around its trend rate as world activity recovers. In parallel, we project RPIX inflation running around 2% through this year, but picking up to reach our target of 2 1/2% at around our two-year forecast horizon. On this basis, recognising that the risks are clearly on the downside of the central projection, we implemented a modest reduction in rates, from 6% to 5 3/4%, in February.

Decision-making under conditions of uncertainty lies at the core of any business activity, so I was once taught, and that is just as much true of our job on the MPC as for yours. We all of us get used in our professional lives to looking through a glass darkly. But in relation to prospects for the economy, that is even more than usually the case now, given the uncertainties we face. Looking ahead, we can in a sense see two rather different pictures, one superimposed on the other. One is the domestic economy, where demand remains reasonably well sustained and now, as I have indicated, better balanced than it was; employment remains high; and consumer and business confidence both seem reasonably up-beat. The other picture is the international environment, where the US slowdown is likely to have a dampening effect, but how quickly, and on what scale, and for how long, remains uncertain. Since the UK is not, except literally, an island, these two pictures do not mesh. But it is not easy to see how they will coalesce into a single image. The operation of monetary policy is often said to be more of an art than a precise science. But none of us can claim to be a Michelangelo. So let me take you briefly through three particular areas of uncertainty we face, in the hope that, when we get to the discussion session, you will be able to add definition and colour to my half-formed sketches.

First, the slowdown in the US is an important area of uncertainty because, if the downside risk of a deeper or more prolonged slowdown materialises, we would face slower growth and lower inflation in the UK than we are projecting on our central projection. That would, of course, be grounds for us to contemplate further easing in our monetary stance. That follows because our inflation target is, importantly, a symmetrical one: we need to be just as ready to contemplate easing if we see evidence on the downside of the economy underperforming, and hence the likelihood of inflation running over time materially below our 2 1/2% target, as we would be to exercise restraint on the upside. We take this symmetrical nature of our responsibility very seriously and there is undoubtedly a significant risk that the US slowdown could have a material dampening effect on UK activity.

Analysts have used a large part of the alphabet to try to describe various views of how the US economy may develop. I am not sure that I find any of these pictograms particularly helpful, not least because people are sometimes pretty vague about vital details like the dimensions of the letter they favour or the angle of its arms: a big V, after all, can feel awfully like a U when you are down the bottom and trying to find your way up again.

The short answer is that none of us can pretend to know precisely how the story will develop. It will be important to keep an open mind and be prepared to adapt our assessment in the light of actual events. But in doing so, there are four considerations that I would suggest are particularly germane to this first area of uncertainty.

First, we need to recognise that we are talking of slowdown in the US from what have been extremely buoyant rates of growth, maintained for several years past, as the US economy has reaped the benefits of the application of information technology and the rise in productivity growth that had engendered - the new economy. There is plenty of evidence that growth in the US needed to slow somewhat, to alleviate imbalances in the economy. So part of what is happening should be helpful in providing a sounder base for sustainable recovery.

Secondly, the new economy is, in the US, a reality: there plainly has been a continuing process of improvements in efficiency, achieved by harnessing the benefits of IT, which have raised the growth capacity of the economy. It seems unlikely that those gains will vanish into the night and, if they remain in place, they should provide a basis for a recovery in US growth when the present adjustment has run its course.

That, of course, says nothing about how long the adjustment may take. But a third important feature is that the Federal Reserve has demonstrated a willingness to act rapidly and vigorously in easing monetary conditions in response to the downturn. Monetary policy cannot remove economic cycles. But active and intelligent management of interest rates can help substantially to alleviate the severity of the adjustment. And a fourth factor suggests that the markets share this view. In the situation where some forecasts have been extremely pessimistic, one might expect markets to adjust correspondingly in an abrupt fashion. In the event, in the foreign exchange markets the dollar overall has remained rather steady; and the short-term interest rate futures curve implies that rates are expected to bottom out later this year and then begin to rise. Moreover, while the stock market has fallen back over the past year from what many felt were unrealistic levels, and has been volatile again in recent days, the downturn in the mainstream market has so far been relatively limited, with the greatest fall concentrated in more speculative stocks. Equity valuations are always uncertain at times of adjustment, and we could see some continued volatility in that area, but the overall picture is that the markets as a whole are "looking through" the present slowdown, on the basis that they see a reasonable prospect for a recovery in US growth after the present adjustment.

A second area of uncertainty lies much closer to home, and happily its ramifications are almost wholly beneficent. This is the question of whether changes in the supply-side of the UK economy mean that we can hope to achieve higher rates of sustainable growth, consistently with our inflation target, than has been possible in the past.

One essentially empirical argument that is sometimes made to suggest that we can achieve faster sustainable growth is that inflation has in fact run a little below our target for most of the past two years. This is not in itself a particularly powerful argument, because the undershoot has been marginal and probably owes a great deal to the unexpected strength of sterling. Indeed, before we began to track a little below the target, we had for around two years been tracking above it.

Nonetheless, the strength of demand in the economy does seem to have exercised less upwards pressure on prices over the past two years or so than we would have expected from earlier experience; and this applies both to prices of goods sold in the product market and to pay and earnings in the labour market. Why is this? In the product market, one factor may be greater competition, which has caused producers and retailers to accept lower margins. Another factor may be new forms of marketing and retailing, for example the spread of e-commerce. This may have cut the cost of distribution, and it may also have intensified consumers' awareness of prices and their resistance to price increases, by enabling them to compare prices more easily. Another possibility is that we may be seeing an increase in productivity growth, perhaps stimulated by the pressures many businesses faced from the strength of sterling, and perhaps also arising from the application of IT - possibly the beginnings of the arrival of the new economy from across the Atlantic. In the labour markets, reforms which have made possible greater labour flexibility, and competitive pressures which have stimulated firms to adapt more quickly to changes in their business environment, may underlie the more benign performance of real earnings growth. More widely, the greater stability the economy has enjoyed in recent years from the medium-term framework that governs both fiscal and monetary decisions may, by stabilising inflationary expectations at a low level, have made it less attractive, and more risky, to try to raise prices even when demand is strong, and may also have enabled industry and commerce to plan their business activities on a sounder and more forward-looking basis.

There is plenty of evidence that all these factors are, in varying degrees, at work in the UK; and they offer the prospect of genuine improvements in the functioning of the economy. But the question is - on what scale, and are the improvements temporary or here to stay? We take considerable care to try to factor these developments into our decisions on interest rates, but the difficult judgment is to assess how much faster the economy can grow as a result without jeopardising our inflation target. My own view is that supply-side improvements are delivering benefits, but the process is a gradual and progressive one, rather than any sudden leap forward. Miracles in the real world are pedestrian affairs, arriving step by step. The appropriate response for us in setting interest rates, therefore, is to try to stay in step and keep pace - not running ahead, but equally not lagging behind.

The third and final area of uncertainty I want to focus on is the underlying strength of demand in the UK economy. The US slowdown may, as I have said, have some dampening effect on other countries, including the UK. The supply-side improvements I have described may enhance our growth capacity. Both these factors could provide grounds for the monetary stance to provide more stimulus to the economy, depending on how events develop. But a third area of uncertainty - the underlying strength of demand in the UK - could point to less need for stimulus. Consumer spending may be slowing somewhat, but it remains relatively buoyant. Retail sales continue to grow and housing market activity may be picking up. Consumer and business confidence remains steady, with new orders holding up well. The easing in sterling has improved our competitiveness in key export markets. Business investment is picking up. The planned increases in government spending are beginning to come through. Employment remains high and earnings are showing signs of some upwards creep as businesses experience skill shortages. All of this is welcome evidence of a healthy and thriving economy, and, with inflation remaining low, it is a performance that can be sustained without immediate risk of overheating. But it is also a situation in which cost and price pressures can begin to build up. The task of the MPC is to ensure that this does not happen, by keeping inflation in line with our target so that the economy can continue to grow at a sustainable rate.

The uncertainties I have described thus lie in both directions: the economy could grow more strongly or less strongly than we currently project, though the risks lie predominantly on the downside. The uncertainties are probably rather greater than normal just at present, but we can take some confidence from the underlying soundness of the economy. So we address the uncertainties from a position of strength. That does not mean that the ride may not be bumpy at times, but it does mean that we have grounds for reasonable optimism that we will come through the present uncertainties in good shape.