Mervyn King: Monetary policy developments

Speech by Mr Mervyn King, Governor of the Bank of England, at a dinner hosted by Scottish Financial Enterprise (SFE) and Edinburgh Chamber of Commerce (ECC), Edinburgh, 12 June 2006.

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It is 230 years since David Hume died and Adam Smith published *An Inquiry into the Nature and Causes of the Wealth of Nations*. Economists will be forever indebted to two of the greatest minds of the Scottish Enlightenment. Both Smith and Hume were members of the Poker Club in Edinburgh, formed, as the name might suggest, to stir up opinion and make the sparks fly. Alexander Carlyle described the Club as so "frugal and moderate" that "a very constant attendant told me that he never observed even an approach of inebriation on any of the members". Perhaps that's why it faded away in the 1780s. In any event, I'm glad we are not at the Poker Club tonight, but enjoying your splendid hospitality here.

Given Edinburgh's importance to the Scottish Enlightenment, it is appropriate that I start by discussing an intellectual puzzle. The puzzle is the following. After 1945 governments felt they had the secret to managing the economy. They thought that by boosting the level of demand through higher government spending and lower interest rates, they could secure permanently higher levels of output and employment. If we were prepared to accept a somewhat higher rate of inflation, then we could achieve a somewhat higher rate of economic growth. In other words, there was a trade-off between inflation, on the one hand, and employment and output, on the other.

There did seem to be something to this proposition in the short run. But in the 1970s, economists and governments alike came to recognise that higher inflation did not, in the long run, lead to higher output and employment; rather it led simply to even higher inflation. Inflation accelerated if economic activity was run at too high a level. In other words, if we plot a graph with inflation on the vertical axis and unemployment on the horizontal axis, we should expect to see a vertical line. In the jargon of economists this is known as a vertical Phillips curve, showing that there is no trade-off between inflation and unemployment in the long run (shown in Chart 1).

This conventional wisdom has governed macroeconomic policy in almost all advanced – and indeed emerging market economies – ever since, and underlies our inflation targeting framework in the United Kingdom. That's the theory. Does it work in practice? Well, if you plot a graph of inflation against unemployment in the UK since the adoption of inflation targeting at the end of 1992, you find that far from being vertical, the Phillips curve has in fact been completely horizontal (see Chart 2). The conventional wisdom appears to have been overturned.

Chart 1. The Vertical Phillips Curve

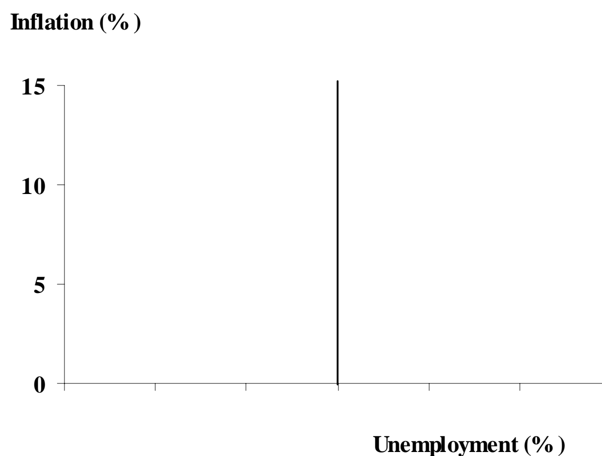
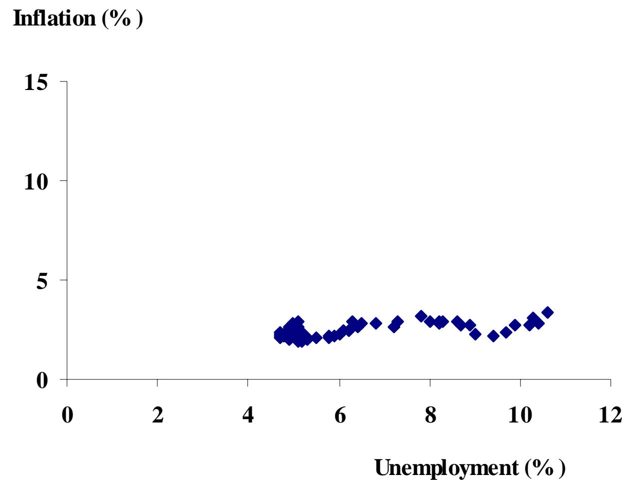


Chart 2. The United Kingdom Phillips Curve, 1993-2005



Source: ONS. The unemployment rate used here is the Labour Force Survey measure. Inflation is measured using the Retail Price Index excluding mortgage interest payments (RPIX).

So what is going on? The explanation is, I believe, straightforward, but it contains some important lessons for the conduct of monetary policy today. In the 1950s and 1960s our experience was that the rate of structural unemployment was rather stable, so that large swings in the growth rate of money spending eventually showed up in movements of inflation. In those circumstances the Phillips curve does indeed appear vertical. But since 1992 monetary policy has kept inflation broadly constant – within 1 percentage point of its target every single month since December 1992 – while structural changes have reduced the sustainable rate of unemployment in every part of the United Kingdom – including Scotland. So the Phillips curve appears horizontal.

In the decade up to 2004, that is until the recent slowdown, unemployment fell from double-digit levels to around 5% on the internationally comparable measure and to 3% on the claimant count. Over the same period, employment grew at its fastest rate over any peacetime decade since 1920, raising, probably temporarily, the growth rate of the supply capacity of the economy. Output growth was noticeably faster than its post-war average. Behind that expansion were three significant structural changes: one at home and two overseas.

At home, there has been a sequence of reforms to the labour market which began in the 1980s and have continued since. Reforms such as the New Deal and Working Tax Credit have encouraged benefit recipients back to work. Changes to pay bargaining and a decline in the share of wage settlements covered by collective bargaining have made the labour market more flexible. Those reforms reduced the rate of structural unemployment.

The two other structural changes reflect globalisation and the openness of the British economy. The first is the rise in the prices of the goods and, especially, services that we export relative to the prices of goods and services that we buy from abroad. The so-called terms of trade have improved markedly over the past decade. Countries such as China and India are now major players in the world trading system, and the prices of manufactured goods globally have fallen as a result. That has produced changes in the pattern of international trade, and in our own industrial structure. Although those changes were, and are, uncomfortable to make, they benefit us all as consumers. The rise in the value of what we can buy with our take-home pay has allowed businesses to recruit from a larger pool of labour without having to raise wages.

The other factor is migration. Over the past few years, the impact of migration, particularly from the new member countries of the European Union, has been substantial. The official data on total net migration are derived from small and incomplete surveys, so we cannot pretend to have an accurate idea of the real extent of migration. But, based on responses to the International Passenger Survey, net inward migration between 1995 and 2004 was estimated to have been 1.3million, compared with a rise in the labour force as a whole of 1.7 million. We do know that the labour force has recently been expanding twice as fast as in the rest of the post-war period. Migration on this scale raised the

potential growth rate of the UK economy and probably dampened the response of costs and prices to changes in demand.

That was the past. What of the future? Is there a lesson for the Monetary Policy Committee from the experience since 1992 of stable inflation with large changes in unemployment? I think there is. It is that the MPC, in trying to keep inflation close to our 2% target, must recognise that movements in demand and employment cannot be considered independently of changes in the structure of the economy. Focussing too much on short-run movements in demand may lead it to misjudge the outlook for inflation. It is not possible to form a view about the extent of spare capacity in the economy – the so-called output gap – without explicit judgements on how much the economy is capable of producing. But it is really quite difficult to disentangle movements in the output gap from changes in supply capacity. One economist's output gap is another economist's change in supply potential.

That issue has been central to the deliberations of the Monetary Policy Committee in recent months. The current outlook for inflation – and hence interest rates – depends not only on the prospects for demand but also upon whether the changes to the supply capacity of the economy that we observed in the past will persist or reverse. Over the past year or so, a degree of uncertainty has entered the economic landscape on both the supply and demand side.

So what is causing this uncertainty? On the **supply** side, inflows of migrant workers from the new member countries of the EU remain high. That may or may not continue, and we cannot be sure that migrants would stay in the UK if the labour market were to turn down. And it is also unclear whether businesses will be able to recruit staff as easily as in the past when, as the prices of imported goods and services fell, the real value of take-home pay rose without higher wage settlements. Last year, non-oil import prices rose, depressing the growth of real take-home pay. And oil prices increased further.

On the **demand** side, our central view remains a relatively benign one. The economy slowed in the first half of last year, led by consumer spending. But growth has begun to pick up. Averaging the growth rate of consumer spending over the final quarter of last year and the first quarter of this, shows that consumption growth has returned to not far off its long-run average. Export growth and business investment both seem to be recovering. So in its May *Inflation Report*, the Monetary Policy Committee had, as its central outlook, a return to steady growth with inflation close to the 2% target. But there are many risks and those have been bought into sharp focus by the recent financial market turbulence. And, just as for England in the World Cup, the threats come mainly from the rest of the world.

The recent volatility in financial markets is reflecting the real risks which face us as, after a period of robust world economic growth, we approach a somewhat bumpier stretch of the road. A rebalancing of global demand is desirable, but the way ahead may not be smooth.

One risk is that during the fastest three-year period of world economic growth for a generation, monetary policy around the world may simply have been too accommodative. In the main industrialised regions – the US, Euro area and Japan – official interest rates were very low for a long period. The liquidity created by low official interest rates around the world has helped to push down long-term real interest rates and compress credit spreads to unusually low levels. That monetary stimulus is now being withdrawn. Since January, long-term interest rates have moved up, and now other asset prices are responding. So far we have seen little more than a modest correction to the prices of a wide range of assets that had risen sharply over the previous two years. The realisation that such levels of asset prices were unlikely to be sustainable, coupled with a tightening of monetary policy in many countries, has injected uncertainty into financial markets. And it is hardly surprising that, as investors searching for yield realised that they might have underestimated the uncertainties, the price of risk moved up.

Even though the monetary stimulus around the world is now being withdrawn, its effects are still being felt. There are some signs of inflationary pressures in the main industrial countries. Even in China, with its growing manufacturing base and large pool of labour, some indicators are showing upward pressures on export prices. And in turn that is raising our import prices, over and above the increases resulting from higher energy costs.

At home, we can take some comfort from the fact that, despite sharp increases in energy prices, both consumer price inflation and inflation expectations have remained close to the target. Pay pressures in the labour market are muted, reflecting in part the need of employers to adopt a tough stance in wage bargaining when faced by such large increases in other input costs. Companies facing higher costs for energy, raw materials and other inputs, have been willing to offer only moderate wage increases in

order to minimise the squeeze on their profit margins. The rapid rise in input prices and the muted degree of pay pressures are not independent of each other.

Inflation expectations – whether measured by household surveys or implicit in government bond yields – have moved up during the course of this year. Although not of serious concern as yet, the MPC will monitor inflation expectations carefully. Inflation itself remains volatile as increases in oil and natural gas prices pass through to household bills. Those increases will dampen the growth of real household disposable incomes and moderate consumer spending.

So the economic outlook is far from certain. In these circumstances the Monetary Policy Committee must examine carefully all information, learn and, if necessary, revise its judgements, and question all received wisdom. In other words, it must be enlightened.

The Scottish Enlightenment, it is generally agreed, began and ended in the 18th century. Our present framework for monetary policy is of more recent vintage. But just as the Scottish Enlightenment still influences our thinking today, so the twin features of that framework – namely inflation targeting and independence of the Bank of England – will be crucial to successful monetary policy in the future.

Just as the Monetary Policy Committee meets monthly to decide on interest rates, so David Hume and Adam Smith met regularly in the Poker Club to debate the policy issues of the day. Hume was an officer of the Club with the unusual title of the Assassin's Assessor, "without whose assent nothing could be done", and whose role was to ensure that in meetings "there was likely to be no bloodshed". So I take it that Hume at least would have been content with last week's decision to leave interest rates unchanged. There is no Assassin's Assessor on the Monetary Policy Committee, nor – you will be relieved to hear – any bloodshed. But, month by month, we shall be debating the prospects for the economy in order to decide in which direction, if any, interest rates need to move.