Rachel Lomax: Perspectives on current monetary policy

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The decade to 2004 was one of the most remarkable in the UK's economic history. For the first time in a generation, inflation was low and stable. Output grew for forty straight quarters, and the unemployment rate fell steadily to levels not seen since the mid seventies. By these high standards, the economy's performance over the past couple of years looks slightly more mixed. After a mild slowdown in the first part of 2005, output has been growing steadily at around its long-term average rate for the past year. The inflation rate has varied around the target. But unemployment has been rising for most of the past eighteen months.

As always, there is more than one view about what may be going on. I want to start by setting current monetary policy preoccupations in a broader context, and highlighting some difficult issues. Was the UK alone in experiencing such unusual economic stability since the mid 1990s? What might have caused it? Was it expected? Can we count on it continuing? And how should monetary policy makers deal with the exaggerated expectations that the stability of the past decade may have encouraged? I don't pretend to offer definitive answers to any of these questions. But they are very relevant to the ways that different members of the MPC think about the current situation, and approach the challenges now facing monetary policy.

The international context

I'll start by looking at the wider world.

The UK was not alone in enjoying a decade of unusual stability. Across the industrialised world, output growth and inflation were less volatile than in the 70s and 80s, though growth was disappointingly weak in Japan and Germany. The slowdowns that followed the East Asian crisis and the stock market crash were relatively mild and short-lived. Economists have named this period the Great Stability (or the Great Moderation, in the US) and contrasted it with the Great Inflation of the 1970s. And there has been a lively but inconclusive debate about how much of this better performance is due to good luck and how much to good policy.

Over the past couple of years there has been a growing view among central bankers and some academics that a substantial part of the 'good luck' story may have reflected the benign effects of globalisation. This realisation has dawned as it has become clear that globalisation is having pervasive effects on our economies, as well as contributing to some trends which are not so immediately favourable.

Globalisation, in the present context, is shorthand for the increasing integration of international markets for goods and services, capital and labour. As we all know from first hand experience, the world economy is being transformed by the lowering of all sorts of barriers to the free movement of people, money, knowledge, goods and services. These trends are, of course, as old as human history. But there have been periods, like the second half of the nineteenth century, when globalisation has proceeded rapidly and periods, like the first half of the twentieth century, when it has gone into retreat. The past fifteen years or so have been a period of major advance as a result of far-reaching political and regulatory changes as well as revolutions in technology and communications.

The pace of change has been striking in several key areas.

First, international capital flows have grown explosively, as financial markets have become more integrated. As a result, the value of the global stock of assets in cross-border ownership tripled over the ten years to 2004. As well as increasing the scope for mobilising savings and allocating capital across different markets, the development of deep and liquid international financial markets has opened up new possibilities for diversifying risks and smoothing the adjustment to unforeseen events. This should promote both economic stability as well as growth.

Second, the sheer scale and pace of economic development in China is without precedent. What is not new is its strong export orientation – this was the route taken by Japan and the East Asian Tiger economies. China is now a key part of both global and regional supply chains for the production of low-cost manufactured goods. China now produces 80% of the world's photocopiers, 50% of the world's textiles and 50% of the world's computers. These developments will tap the labour of hundreds of millions of people who were previously effectively outside the global market place. They are also triggering urbanisation – and infrastructure investment – on a scale, and at a rate, which makes our own Industrial Revolution look sedate, even puny.

The Chinese Government expects 300 million people to migrate from the countryside to urban areas over the next 20 years. China had no motorways in 1988, now it has 41,000 kms, second only to the US. It is adding the equivalent of the UK's total power generating capacity every year. Beijing alone plans to build 15 new metro lines by 2020, to create a network larger than the London Underground. No surprise, then, that China consumed 50% of the world's cement last year.

Third, and more tentatively, there seems to have been an increase in the international mobility of labour. This is the area where the continuing, largely political, barriers to free movement are most apparent, and where, partly in consequence, it is hardest to assemble reliable information. Nevertheless, many developed countries seem to have been experiencing increases in their long- and short-term immigrant workforces, both skilled and unskilled - notably the US, where the foreign-born work force is now around 15% of the total, and a number of Southern European countries. Italy and Spain both had increases in their foreign-born workforces of over a million in the five years to 2004. There have been smaller, but still sizeable, increases, in Germany, Sweden, Ireland, the Netherlands, and the UK.[1]

It is too soon to assess the full impact of these developments on the performance of industrial countries. A few obviously important effects have been identified but they may not turn out to be the most significant in the long term.

Most comment has focused on the direct effects of the emergence of China on relative prices, especially the price of manufactures relative to other goods and services. The emergence of an economic superpower with abundant supplies of labour and a relatively poor natural resource endowment has probably had several effects. First, it has pushed down on the price of manufactured goods over a long period of time. Across the world's industrial countries the real price of goods (adjusted for general inflation), fell by over 10% between 1995 and 2005. Second, in the last couple of years it has helped to fuel a sharp surge in world prices for energy and other commodities. Between the beginning of 2004 and their peak in August of this year, world oil prices rose from $30 to $78 a barrel. There have been comparable increases in the prices of metals and other raw materials over the same period.

Economists have also speculated that globalisation may be changing wage- and price-setting behaviour in developed countries, by adding to the competitive pressures facing domestic producers and wage earners. This is not just a reflection of increased competition from cheap manufactured imports, and the greater availability of migrant labour to ease domestic labour shortages. A Welsh audience will need no reminding of the many ways in which both inward and outward foreign direct investment can affect domestic employment opportunities. Hard as it is to quantify, the net effect of these trends may have been to reduce the sensitivity of domestic inflation to changes in the margin of spare capacity in the economy.

But while these effects go some way towards explaining why the global inflationary climate may have been relatively benign over much of the past decade, I think they fall short of providing a complete explanation for the strength and resilience of global output growth. For this we might look to the more elusive influence of financial integration, and the added impetus to global growth provided by the increasing weight of fast-emerging market economies, particularly in Asia.

It is just worth pausing on the remarkable ease with which the world economy has apparently absorbed the impact of sharply higher oil prices. World output expanded at its fastest rate for 30 years in 2004, and this year growth looks like being as strong again. One obvious explanation is that both high oil prices and the strength in the world economy have reflected the rapid pace of development in

1 Data from OECD's *International Migration Outlook 2006*.

China, where growth has been around 10% a year since 2004, and which last year was responsible for nearly half of the growth in total world oil demand. So the two have helped to offset each other.

But the recent behaviour of oil prices has also reflected supply-side problems. The rapid growth in demand seems to have taken oil producers by surprise. The world is currently operating on a very thin margin of spare oil production capacity as a result of low investment in the 1990s. The result is that oil prices have also been volatile, as well as high, moving sharply in response to geopolitical and weather-related news, as well as changing expectations about world demand and supply. In time, both supply and demand will respond to higher prices, but the lead times for new production capacity are very long – around ten years to develop a new field.

High and volatile oil prices pose a grisly challenge for monetary policy makers. But so far there has been no surge in inflation across the world as there was following the oil price increases in the 1970s. True, headline inflation rose initially in many countries, especially the US, where it ticked up to nearly 5%, before falling sharply to less than 1.5% when oil prices fell this autumn. But central banks have been on the alert for any signs that higher oil prices would feed into higher wages, and so trigger an inflationary spiral. And so far wage growth has remained moderate in all developed countries, including the UK.

Monetary policy

Inflation has remained firmly under control despite a doubling in the price of oil. This, to my mind, is striking evidence of a sea change in policy since the 1970s. But how far was the Great Stability due to good policy, as opposed to globalisation or plain good luck? This broader question is probably unanswerable, but a couple of points are worth making.

First, there is no doubt that, in the medium term, the actual inflation rate is determined by the Bank of England. Our decisions about interest rates – the price of money – determine the amount of total money spending in the economy. The rate of inflation reflects the difference between this spending and what the economy is capable of producing – total supply. The faster money spending grows relative to supply, the higher inflation will be. In that sense low inflation reflects policy, not luck.

But external conditions may make it more or less easy to keep inflation low and stable. If the Bank aims for a low but positive rate of inflation, and imported goods prices are falling, the prices of other goods and services will have to rise faster to compensate. So for example, the prices of imported goods and services *fell* by 13% between 1995 and 2004, while the prices of other consumer goods and services *rose,* on average, by around 20%. To produce this result, and keep overall inflation close to target (as it was), the Bank was probably able to keep interest rates lower than they might otherwise have been.

That’s why people sometimes say that the falling world prices resulting from globalisation have acted as ‘favourable tailwinds’ for central banks over the past decade. And why, over the last couple of years, there have been worries that high and volatile energy prices would provide ‘strong headwinds’.

Second, there have been important innovations in the practice of monetary policy over the past decade. These have not been confined to the UK - there is an international traffic in good monetary policy ideas, as in almost everything else. So while the UK was a pioneer in some respects, our current approach to policy is more fairly described as close to international best practice. There’s been a widespread move to give central banks more independence, with clear objectives and a strong commitment to transparency and accountability. In the UK, we adopted a target for inflation as long ago as 1992 and the whole framework for taking decisions about interest rates was overhauled after the 1997 election.

I am sometimes asked how different British economic history would have been if we had adopted the present approach to monetary policy at various landmark dates – such as 1976 or 1979. This is a hard one.

Tolstoy famously said that all happy families are alike, but unhappy families are each unhappy in their own way. It is rather the same with monetary policy. There are very many ways of getting it wrong – the UK has some experience here - but the hallmark of all good monetary policy is what Hans Dietrich Tietmeyer (President of the Bundesbank in the 1990s) used to call ‘the three Cs’: credibility, consistency, and continuity.

My own view, for what it is worth, is that there has been a virtuous circle over the past 10-15 years when central banks have taken advantage of relatively benign global conditions to embed the three Cs, by successfully implementing better policy-making frameworks and establishing strong reputations for competence on the back of excellent track records. The Bank of England would have faced a tougher challenge in doing this in the economic circumstances of the 1980s, and certainly the 1970s – even if the political consensus had existed to support such an experiment (which it didn't). Even the Bundesbank built up its formidable reputation during the German post war economic miracle.

That said, I do not think there is any doubt that the new approach to monetary policy did represent a major advance on what went before. In what way? Inflation targeting, the UK's current approach, broke with past attempts to run an independent monetary policy by offering commitment and clarity. For the first time, the Government and the Bank of England committed to clear objectives, clear communications and clear lines of accountability. We now have a decision-taking framework which allows monetary policymakers plenty of room for discretion, while forcing them to provide a full explanation of their thinking.

By hook or by crook, the fact is that central banks do now enjoy considerable credibility. They treasure that legacy, much like any blue chip company, and for many of the same reasons. Credibility, and the trust that flows from it, is worth a great deal in policy-making, as in business. If people believe that the Bank will act to keep inflation low and stable they will factor that in to their decisions. (They may have been doing this recently, in judging how to respond to higher oil prices.) If so, that in turn makes it easier for the Bank to keep inflation on track, and reduces the fluctuations in output that controlling inflation can involve. So it is not implausible to assign a significant role to better policy in explaining the Great Stability.

But the extraordinary stability of the past decade may have given people an exaggerated idea of what to expect of monetary policy. While the Bank can deliver low inflation, we cannot reliably deliver rock steady growth in output and employment, still less falling unemployment. Whether or not that happens depends on events in the wider world – what economists like to call 'shocks' - and other economic policies, including taxes and regulations. All we can do is try to keep demand growing in line with supply.

And in fact, most economists a decade ago would have said that the Great Stability, as we have experienced it in the UK, represented a pretty unlikely set of outcomes. The then Governor, Eddie George, said he hoped that low inflation would contribute to a more stable economy but warned: 'We cannot hope to achieve that with any great precision'[2].

The MPC's formal remit from the Chancellor, originally drafted nearly a decade ago and still in force, seems to be predicated on a more turbulent world. It makes specific allowance for situations in which inflation might be thrown sharply off course. It reads:

> 'The framework is based on the recognition that the actual inflation rate will on occasions depart from its target as a result of shocks and disturbances. Attempts to keep inflation at the inflation target in these circumstances may cause undesirable volatility in output. But if inflation moves away from the target by more than 1 percentage point in either direction I shall expect you to send an open letter to me setting out the reasons why inflation has moved away from target …and the period in which you expect inflation to return to target'

In 1998 Charlie Bean, now (but not then) the Bank's chief economist, calculated that open letters might be triggered at least 40% of the time, on the basis of past experience[3]. This did not seem unreasonable at the time. But after 114 monthly decisions, inflation has always been within 1 percentage point of the target. And I take the fact that no Governor has yet sent an open letter as further evidence that there has indeed been an unexpected increase in stability.

[2] Mais lecture, June 1997.

[3] "The new UK monetary arrangements: a view from the literature", Charles Bean, *Economic Journal* 1998.

Where are we now?

Are we now entering choppier waters? The world economy continues to grow at an impressive rate, with few signs of sustained inflationary pressure. Globalisation continues apace. But it is not difficult to think of things that could go wrong, ranging from an outbreak of protectionism, to another sharp surge in oil prices in response to geopolitical events, to a sharp correction in housing markets, which in a number of countries are very richly valued.

But mindful of the old Chinese proverb that 'He who lives by the crystal ball will die from eating broken glass' I will stick to interpreting what's happening in the economy right now. I'll focus on two issues: first, what's happening to inflation? And second, why has unemployment risen?

Over the past couple of years, the headline rate of inflation has been pushed about by sharp movements in energy prices. Back in the autumn of 2004, CPI inflation was closer to 1% than the 2% target. A year later it had risen to 2.5%. It then fell back below target until the spring of this year, when it moved back up to around its present level of just below 2.5%.

The first spike in inflation above the target – in the autumn of 2005 - corresponds with the very sharp rise in petrol prices around the time of hurricane Katrina. The second upward movement corresponds with the big jump in domestic gas and electricity prices this spring. This autumn petrol prices have fallen back sharply from their August peak. But CPI inflation has scarcely changed. Why? The simplest explanation is that the recorded inflation rate is still being boosted by high utility prices, and the effect of lower petrol prices has been partly offset by high seasonal food prices and the introduction of university tuition fees. Any broader-based pick up in inflation has been relatively small.

Of course, life is not quite that simple. The prices of individual goods and services go up and down all the time. And large individual price changes - whether or not you take them out of your preferred measure of inflation, as some central banks do – always add to the difficulties of interpretation. The MPC needs to focus on persistent price movements. It has to look through short-run volatility and judge how fast the average price level is likely to rise over the next few years. This is the time horizon which is relevant for policy, since changes in interest rates take a year or two to have their effect. The current rate of inflation says rather little about where inflation is likely to go. We need to judge, as best we can, the changing balance of supply and demand in the economy – inflationary pressure.

But why has unemployment been rising? One possibility is that the labour market is still feeling the effects of the period of below-trend growth in late 2004 and 2005. We know that employers tended to hold on to people then rather than letting them go, probably because they expected – rightly as it turned out – that the slowdown would be shallow and short-lived. As demand picked up, they were able to work their existing staff harder again, rather than hiring new people straight away.

But meanwhile the potential workforce – the number of people in work or who say they would like to work - has been growing at its fastest rate in twenty years. This reflects a number of developments. First, the influx of workers from abroad, including from the European Union accession countries. The precise figures are very uncertain, not least because people come and go a lot, but recent research[4] estimates that 2005 probably saw the largest ever entry of foreign workers to the UK, totalling around 400,000 – equivalent to around 1.5% of total employment (although outflows have probably risen, too). In addition, older workers are increasingly likely to stay in work – people above pensionable age accounted for a quarter of the growth in the work force over the past year; and Government policies are encouraging people on benefit back into work.

The result has been that the labour force participation rate, the number of people in work and the number who are unemployed have all been rising at the same time – a fairly unusual combination. A faster growing labour force potentially raises the amount the economy can produce. Rather like raising the economy's speed limit, it implies that it can grow faster without hitting supply constraints and generating inflationary pressure.

That may be the situation right now.

In any event, putting all this together with the impact of energy-related price movements, I do not read the fact that inflation is currently above target as convincing evidence that the economy is overheating.

[4] "Foreign labour in the United Kingdom: current patterns and trends", John Salt and Jane Millar, *Labour Market Trends,* Office for National Statistics, October 2006.

While demand has not been growing unusually slowly over the past year, it is now two and a half years since it grew at a rate significantly above its longterm average. And that average could be an underestimate of how fast we could safely grow.

Even so, there is a risk that a temporary rise in the inflation rate will spark off inflationary pay increases. And if that were to happen, the MPC would need to raise interest rates to restrain demand and bring inflation back to target. I thought this risk looked quite significant in August when – as the Governor said at the time – the Committee saw a 50/50 risk that consumer price inflation would rise above 3% this winter.

At the same time, the latest figures were confirming that the economy had recovered its momentum. So it seemed prudent to take back the modest cut in interest rates which the Committee had narrowly voted for the previous August. I cannot speak for other MPC members. But for me, raising rates this summer was akin to buying insurance against the risk that a possible spike in inflation – which we could do little to avert – would cause people to revise up their expectations about future inflation, and maybe dent the credibility which the Committee had built up over the previous decade.

Since August, the short- and medium-term outlook for inflation have both improved somewhat, as world oil prices have fallen back very sharply, and sterling has risen. The odds of inflation rising above 3% have lengthened. There are still no real signs of pressure in the labour market. And while it never does to be complacent about pay, in today's labour market there is quite a difference between asking for higher pay and getting it – even in sectors not exposed to the full blast of global competition.

There are, of course, still some risks. But insurance is never costless. In the case of monetary policy, taking out insurance against risks that don't materialise can inject unnecessary volatility into the economy, with consequences for jobs as well as demand. That is why we have the remit we have. It gives the MPC scope to exercise its judgement. But those are precisely the sort of judgements about which reasonable people can – and probably - should disagree. So it was this month.

One judgement about which reasonable people could disagree is how robust the Committee's treasured credibility might be, if it ever came under real pressure. It is often said that it takes decades to build a high reputation but only a moment to lose it. And there are plenty of business horror stories that seem to prove the point.

What moral should a member of the MPC draw? Is there a risk that the Great Stability has conferred a golden halo on the Committee which is only partly deserved? And that a more turbulent set of events could cause that halo to slip, and possibly trigger a sharp loss of credibility?

The MPC clearly cannot afford to be complacent. And we – and you - need to be realistic about what monetary policy can – and cannot - achieve. That said, I am confident that our present policy framework does have the capacity to withstand more turbulent times, should they materialise.

After all it was designed for them.