# Mervyn King: Changes in the UK economy and the role the Bank of England can play in supporting them

Speech by Mr Mervyn King, Governor of the Bank of England, at the Black Country Chamber of Commerce, West Midlands, 19 October 2010.

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Ladies and Gentlemen,

It is good to be back in the heart of Britain – in the Black Country – because the Bank of England has strong connections with the area. Both I and Deputy Governor Paul Tucker hail from Wolverhampton. And I am delighted that all nine members of the Bank's Monetary Policy Committee are in the West Midlands this week on an MPC road-show to see for themselves the state of business in the region.

The Black Country is the home of the original Industrial Revolution. Too often those historic events are painted as just that – past glories of little relevance today. But there is no better place to see evidence of how the British economy can adapt than in the Black Country. Indeed, one example can be found behind this building. Dudley Canal No. 1 was part of a network of canals, central to the Industrial Revolution, along which the products made here – especially iron and steel – were transported throughout the country. At its peak, there were 5,000 miles of canals in Britain. Of course, the importance of canals as the arteries of industry later declined and by the late 1960s only 2,775 miles were navigable. But the regeneration of urban communities, and the efforts of British Waterways, have reversed this decline. The number of miles is now increasing. Last year, 13 million people visited our canals and the number of boats is actually higher now than during the Industrial Revolution. Such examples are important because our economy faces the prospect of change again. After an unprecedented financial crisis and deep recession, the UK economy needs to rebalance. Tonight I want to talk about what those changes will entail and the role which the Bank of England can play in supporting them.

The Bank of England's key role has always been to ensure that the economy is supplied with the right quantity of money – neither too much nor too little. For fifty years, my predecessors struggled to prevent there being too much, so leading to inflation. I find myself in the opposite situation having to explain that there is too little money in the economy. But, in the wake of the financial crisis, and the sharp downturn that followed, the amount of money in the economy as a whole – broad money – is now barely growing at all. That is restraining activity and pushing down the outlook for inflation. So the Bank of England has taken extraordinary monetary policy measures – through our so-called "quantitative easing" programme of asset purchases – to ensure that the amount of money starts growing again in order to support a recovery and keep inflation on track to meet our target in the medium term.

My first speech as Governor – in 2003 – was also in the Midlands. In it, I talked about the non-inflationary consistently expansionary – or ***"nice"*** – decade from the early 1990s to the early 2000s. I argued that the next decade was unlikely to be as nice because, and I quote, "when shocks, as they will, hit our economy it is almost inevitable that there will be somewhat greater volatility of both output and inflation than the remarkable stability to which we have become used in recent years". I certainly did not anticipate the scale of the downturn in the world economy that followed the collapse of the banking system in 2008. But I did point to the need for a rebalancing of demand in the UK economy because, as I said then, "the strategy which the MPC has pursued in recent years – stimulating domestic demand to compensate for weak external demand in the face of a strong exchange rate – carries the risk that there could be a sharp correction to the level of consumer spending at some point in the future".

The counterpart to strong consumption in the past was low saving. Having averaged close to 20% in the 1960s and 70s, gross national savings fell to just 12% of income in 2009 – the lowest since the War. This was all the more remarkable because one might have expected saving to increase as life expectancy rose. In the coming years, we will have to save more, even though the immediate concern is to ensure a recovery in demand. So the case for rebalancing is even stronger in the wake of the financial crisis and recession that followed the ***nice*** decade.

To achieve a rebalancing we need to sell more to, and buy less from, economies overseas. To close the gap between exports and imports, more than half a million jobs will probably need to be created in businesses producing to sell overseas – compensating for fewer employment opportunities serving UK consumers or the public sector.

Such an adjustment is unlikely to be smooth. Unless the fall in domestic spending coincides with the necessary increase in net exports, the path for the economy will be bumpy. As a result, it is dangerous to become fixated by the precise profile of quarterly growth rates. The sensible approach is to focus on the big picture. And the big picture is that total output is roughly 10% below where it would have been had the crisis not occurred. The conditions are in place to support a rebalancing at home: in particular the past depreciation of sterling will make UK-produced goods more competitive at home and abroad. But domestic spending has already fallen before a pickup in net exports. This highlights a key role for monetary policy: smoothing the adjustment process by providing temporary stimulus to demand while the rebalancing takes place, so reducing the risk of inflation falling below the target in the medium term.

The biggest risk to an orderly rebalancing of our economy comes from abroad. Efforts to restore world demand are impeded by the scale of the imbalances in trade, which are beginning to grow again. If the UK and other low-savings countries are to rebalance their economies, demand for their products must increase overseas. Lower domestic demand in the deficit countries must be accompanied by strong growth in domestic demand in the surplus countries if the world economy is not to slow. That will require a change in the strategy of those countries that have built their own policies around export-led growth.

In searching for a solution, some ask who is to blame. But that misses the point. Before the crisis, all the main players were rationally pursuing their own perceived self-interest. Policymakers in countries like China wanted to develop via an export-led strategy, and policymakers in the low-saving countries took actions to maintain an adequate level of overall demand, consistent with steady, low inflation. But what seemed to make sense for each player individually did not make sense in aggregate, and we can see the consequences. A key lesson from the crisis is that we must find better ways of ensuring the right collective outcome.

That challenge is clearly visible today. All countries accept that global rebalancing is necessary. But there is a clear difference between the path of adjustment desired by the surplus countries, which are faced with the need for a longer-term structural shift away from reliance on exports, and the path of adjustment preferred by the deficit countries, which are under greater near-term pressure to reduce the burden of debt in both private and public sectors. Tensions between the two groups were evident at last week's IMF meetings in Washington where all the talk was of currency conflicts. Such conflicts are, however, symptoms of a deeper disagreement on the appropriate time path of real adjustment. Since surpluses and deficits must add to zero for the world as a whole, differences between these desired *ex ante* adjustment paths are reconciled *ex post* by changes in the level of world output. And the risk is that unless agreement on a common path of adjustment is reached, conflicting policies will result in an undesirably low level of world output, with all countries worse off as a result.

The international monetary system today has become distorted. The major surplus and deficit countries are pursuing economic strategies that are in direct conflict. And there are some innocent victims. Those emerging market economies which have adopted floating currencies are now suffering from the attempts of other countries to hold down their exchange rates, and are experiencing uncomfortable rates of capital inflows and currency appreciation. So there is more to this issue than a bilateral conflict between China and the United States.

At the G7 meeting in October 2008, I was part of the group of ministers and central bank governors who threw away the prepared communiqué, and replaced it by a bold short statement of our determination to work together. That spirit, so strong then, has ebbed away. Current exchange rate tensions illustrate the resistance to the relative price changes that are necessary for a successful rebalancing. The need to act in the collective interest has yet to be recognised, and, unless it is, it will be only a matter of time before one or more countries resort to trade protectionism as the only domestic instrument to support a necessary rebalancing. That could, as it did in the 1930s, lead to a disastrous collapse in activity around the world. Every country would suffer ruinous consequences – including our own. But, to borrow a phrase, in order to be tough on protectionism, we need also to be tough on the causes of protectionism.

So what needs to be done? Let me suggest two principles for the way ahead. First, focus discussion on the underlying disagreement about the right speed of adjustment to the real pattern of spending. Without agreement on this, policies will inevitably conflict. Once broad agreement is reached, it should be easier to agree on the instruments of policy. Second, in terms of policy instruments, put on the table many potential policy measures – not just the single issue of exchange rates. That should include, in addition to exchange rates, rules of the game for controlling capital inflows, plans to raise saving in the deficit countries, structural reforms to boost demand in the surplus countries, and even the role and governance of the international financial institutions.

What is needed now is a "grand bargain" among the major players in the world economy. A bargain that recognises the benefits of compromise on the real path of economic adjustment in order to avoid the damaging consequences of a move towards protectionism. Exchange rates will have to be part of such a bargain, but they logically follow a higher level agreement on rebalancing and sustaining a high level of world demand.

A natural forum in which to strike such a bargain is the G20. But to turn the regular round of international meetings into a real agreement will require a revolution, different in nature but no less significant, than that which put the Black Country on the map. Landlocked though the Black Country may be, our local economy has always been linked to a wider world – by canal, rail, road, and air, even fibre-optic cable. So the manner and speed with which the global imbalances unwind will have a direct impact on the Black Country and the UK economy as a whole.

Such developments in the real economy are important also for the Monetary Policy Committee, because they are an important influence on our primary goal of ensuring inflation is on track to meet our 2% inflation target.

Recently, inflation has been high and volatile. It is currently above our 2% target. And the aim of the MPC is to bring it down. But as demand rebalances, we should expect some volatility in inflation as well as in the path of output. During 2008, CPI inflation rose to a peak of 5.2%, fell to a low of 1.1% in 2009, before increasing again to stand at 3.1% now. Those movements have mainly reflected changes in VAT, volatile energy prices and pass-through from the past exchange rate depreciation. Together they have pushed up on measured inflation.

Though uncomfortable, it is not surprising that inflation has been more volatile than during the ***nice*** decade. In 1998, before he joined the Bank, Charlie Bean estimated that the normal variation in the economy would lead inflation to be more than 1 percentage point away from target for around 40% of the time. And in the past three years, inflation has been more than 1 percentage point away from target in 17 months, or 47% of the time. Yet that was a period of extraordinary volatility in the economy and at the same time we managed to absorb a 25% fall in sterling's effective exchange rate, something that historically would have created far more serious inflationary problems.

The key question is whether the current inflation rate signals that inflation will persist above target. The MPC is conscious that the continuing high level of inflation poses the risk that inflation expectations may move up. And it may be some while before inflation returns to target. But at present, there is also a risk – at least as large – that once the temporary upward influences on inflation dissipate, the influence of spare capacity in the economy will push inflation below the target. Consistent with that possibility, a range of other indicators – growth in broad money, pay, and the pressure of demand on supply, that together are likely to be a more reliable guide to inflationary pressure looking ahead – all remain extremely subdued. So not only can monetary policy play a role in smoothing the rebalancing process, it needs to do so if the outlook for inflation is to remain in line with the 2% target in the medium term.

Because there are risks on both sides of the outlook, reasonable people can disagree about the monetary policy judgement. In recent speeches, different MPC members have emphasised upside and downside risks to inflation. After the event, no doubt whichever risk has crystallised will be described by the critics as inevitable. Unfortunately, we do not have a crystal ball. So in setting policy today the only coherent approach is to balance those two risks.

The next decade will not be ***nice***. History suggests that after a financial crisis the hangover lasts for a while. So the next decade is likely to be a ***sober*** decade – a decade of savings, orderly budgets, and equitable rebalancing. Our prospects remain closely linked to developments in the rest of the world. But we can influence the outcome, with monetary policy still a potent weapon to ensure that the amount of money in the economy is growing neither too slowly, as in the recent past, nor too quickly so as to reignite inflation. With that, and the inspiration provided by the Black Country's example of how to adapt to economic change, I am sure of one thing. A ***sober*** decade may not be fun but it is necessary for our economic health.