**Mr George talks about monetary policy in the United Kingdom: The Economic Prospect**

Text of the Chancellor's Lecture delivered by the Governor of the Bank of England, Mr E A J George, at Hertfordshire University on 18/02/99.

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As you would expect of a central banker I will talk about monetary policy – under the title of "The Economic Prospect". I will begin by explaining what it is that we are trying to do through monetary policy; then I'll describe how we've been doing, where we are now, and where we might be headed.

## What we are trying to do

So let me begin with what it is that we are trying to do.

In one sense that's very easy to explain these days. The previous Conservative Government had already in 1992 defined the objective of monetary policy in terms of a target rate for retail price inflation. The new Labour Government, immediately on assuming office, similarly defined the objective in terms of an inflation target, but went an important step further. As soon as Gordon Brown became Chancellor of the Exchequer, in May 1997, he announced that he would no longer exercise his powers to set short-term interest rates, which is the heart of monetary policy, but instead he would set the inflation target, and delegate the achievement of that target to a new Monetary Policy Committee to be established in the Bank of England.

This position was subsequently formalised in the new Bank of England Act which came into effect in June of last year. That Act now defines the Bank's objective as "the maintenance of price stability, and, subject to that, to support the Government's economic policy, including its objectives for growth and employment".

Under the Act the Chancellor tells the Bank what precisely we are to understand by "price stability" and he has done this by setting a target of 2½% for a particular measure of retail price inflation (RPIX – which is the RPI excluding mortgage interest payments); and although the Act provides for the Chancellor to set the target each year, the expectation is that it is in practice set for the medium to longer term. That is the political decision. The task of achieving that target – the technical implementation of monetary policy – is then delegated, transparently and accountably, to the MPC. The Government no longer has the power – as it had under the 1946 Bank of England Act – to issue directions to the Bank in the field of monetary policy, except, in the terms of the new Act, "in extreme economic circumstances".

So the objective of monetary policy these days, in this immediate sense, could hardly be clearer; and that objective is accepted across a broad part of the political spectrum.

But it is important to understand that this objective – of permanent effective price stability – is not simply an end in itself.

Now a lot of people think that, because our objective is defined in terms of an inflation target, controlling inflation is all that we at the Bank of England actually care about. We're often described as a lot of "inflation nutters", or even as "pointy-headed industrial hooligans" who don't care at all about real economic activity or jobs – and I don't think these epithets are necessarily intended as terms of endearment! That view I have to tell you is profoundly and fundamentally wrong.

The implication, of those who take that view, is that they think there is a trade-off between inflation and the rate of economic growth; they think that if only we would let up a bit on controlling inflation then we could all enjoy higher activity and lower unemployment and rising living standards, which are, of course, the really good things of economic life. At the very least, they say, if you were a bit less manic in your pursuit of low inflation, we could avoid some of the worst damage that is currently being inflicted upon agriculture, upon large parts of manufacturing, and even some service sectors.

And that might even be true for a time. The trouble is that, in anything other than the short term, it would be likely to mean more rather than less economic damage, and lower rather than higher growth and employment.

Often in the past in this country we behaved as if we thought that promoting higher growth and employment – which I repeat is, of course, what we all want to see – was largely a matter of pumping up demand. We paid too little attention to the structural, supply-side, constraints. All too often we tried to buy faster growth and higher employment at the expense of just a bit more inflation. But that was like trying to squeeze a quart out of a pint pot. And you all know the result: inflation accelerated, often accompanied by a worsening balance of payments, until it could only be brought back under control – as eventually it had to be brought back under control – by pushing up interest rates dramatically and forcing the economy into recession. We get uptight these days when interest rates rise by ¼%: it was only 14 years ago that we were driven to increase interest rates by 4% in the space of 17 days. I don’t need to remind you – or perhaps I do – of the really miserable social as well as economic consequences, as right across the economy people lost their jobs, their businesses and their homes. But even more insidiously, repeated experience of boom and bust produced a pervasive short-termism in business behaviour, which infected both industry and finance, and both employers and employees, however much we all like to blame everyone else. The reality during this period was that everyone was tempted to grab as much as they could while the going was good, because they knew it would not last.

But we have learned from that experience. We’ve learned that in anything other than the short term there really is no trade-off between growth and inflation. What we are trying to do now through monetary policy is to keep overall demand in the economy growing continuously broadly in line with the supply-side capacity of the economy – as a whole – to meet that demand. Both the previous Government and the present one set a low inflation target as the immediate objective of monetary policy, not as an end in itself, but in effect as a barometer of our success in keeping demand in line with supply. So the real aim of monetary policy these days is to achieve stability across the economy as a whole in this much wider sense.

Now, there is not a lot, frankly, that we can do, directly through monetary policy, to affect the supply side – the underlying rate of growth that can be sustained without causing inflation to rise. That depends ultimately on the ingenuity, the productivity, and the flexibility, of the economy, though it can, of course, be influenced by the whole raft of Government policies, ranging from education and health, through taxation and social security, to the balance between regulation in all its forms, including regulation of the labour market, and productive efficiency. Like the setting of the objective of monetary policy, these are, of course, quite rightly, matters for elected politicians.

Monetary policy operates on the demand side. And the best help that we can give is to keep overall demand consistently in line with supply-side capacity – symmetrically not letting it run

above capacity but not letting it fall below capacity either – as reflected in achievement of the inflation target. That way we can moderate rather than aggravate the unavoidable ups and downs of the business cycle, enabling steadier growth, high levels of employment and rising living standards to be sustained into the medium and longer term. And if we can do that, then we will contribute indirectly to the supply side by creating an environment which encourages more rational, longer-term, decision-making throughout the economy.

So that, Chancellor, is what we are trying to do. The debate about monetary policy is not about the ends, it is about the means. We are every bit as concerned with growth and employment as we are about price stability – as anyone in their right mind must be. Permanently low inflation is a necessary means of achieving growth and employment sustained into the medium and long term. I don't think that any of us at the Bank of England or on the MPC would get half the satisfaction that we do in fact get from our involvement in monetary policy, if we thought that controlling inflation was simply an end in itself.

**How we've been doing**

So much, then, for what we are trying to do. How, then, are we doing? Well – whatever you read in the newspapers – the answer is that since we adopted an inflation target as the immediate policy objective, we've actually been doing pretty well.

Inflation over the past six years or so has in fact averaged about 2¾% a year on the target measure and it has recently been almost spot on its 2½% target.

But equally important, total output in this country has grown consistently for almost seven years – 27 consecutive quarters – up to the final quarter of last year, at an average annual rate of around 3%, and that is well above our long-term rate of growth of underlying capacity of some 2-2½%. We were, in fact, over this period steadily reabsorbing the economic slack created by the earlier recession.

Employment has risen on the most recent figures published yesterday, by some 1.8 mn since 1992, to an all-time high of 27.3 mn. And the unemployment rate is at a near 20-year low, not just for the UK as a whole, but in nearly every region in the Kingdom.

Encouragingly these developments in the labour market produced only a rather gradual pick-up in earnings growth compared with past periods of labour market tightening, which was an important factor helping to contain inflation. And our balance of payments remained in surplus on the latest available data – for Q3 last year.

Short-term interest rates – which are currently at 5½% – actually peaked last year at 7½%. For much of my 37 years at the Bank I'd have given my eye-teeth for them to trough at 7½%. Long-term interest rates, which have recently been at around 4½%, are lower than they've been since the late 1950's. That's certainly good for the economy as a whole, though I recognise that it does not necessarily feel good to people living on interest on their savings, even though those savings keep their real value far better than during the earlier period of high inflation.

The public sector's balance sheet is in excellent shape compared with most of the rest of the world – and the Government's borrowing requirement position is strong and sustainable. And

the same is true of the balance sheets of the banking system, and of both the household and corporate sectors.

And on top of all that, England beat the Springboks at rugby – even if our cricketers didn't do so well down under!

Yet all that one reads about – all that anyone wants to talk about apparently – is the bad news.

So let me not disappoint you this evening, and now come on to the bad news.

Where are we now?

By around the beginning of 1997 it was becoming clear that we were once again in danger of having too much of a good thing. Overall output growth needed to moderate if we were not to run up against overall capacity constraints – particularly in the labour market. In fact output growth actually picked up during the course of 1997, from a rate of close to 3% to around 4%, partly under the impact of the windfall effect of building society demutualisation on consumer spending. Aggregate demand growth, in other words, needed to slow if we were to avoid overheating, and that essentially was the background to the tightening of monetary policy during 1997 and the first half of 1998.

But there was a major complication. In the autumn of 1996 sterling's exchange rate against the core European currencies started to strengthen, and by early 1997 it had already appreciated by some 17% against the deutschemark. Although sterling appreciated rather less against the dollar – which also strengthened against the core European currencies over this period – sterling's effective exchange rate index (ERI) still rose by some 13.5%. Sterling went up further against the deutschemark right up until the spring of last year.

It was never entirely clear just why sterling – and the dollar – strengthened in this way, or perhaps more appropriately why the core European currencies weakened, when they did.

It appeared to have little to do with relative monetary conditions between the Anglo-Saxon countries and the Continent. It may have had more to do with market perceptions – or market misperceptions – about the future prospects for the euro. Financial markets appeared at that time to take the view that European Monetary Union was being driven increasingly by political determination – even if that meant softening the interpretation of the economic convergence criteria written into the Maastricht Treaty. They concluded that this implied a broad rather than a narrow initial euro membership; and that that, in turn, implied a weak rather than a strong euro.

But whatever the reason – and whether it was valid or not – the effect of sterling's appreciation was to introduce a pronounced imbalance into the UK economy. It dampened net external demand, and had a restraining influence on cost and price inflation, at a time when domestic demand growth remained unsustainably strong, and when we were approaching full capacity.

We understood very well that, after a relatively favourable exchange rate environment, following our exit from the ERM, the abrupt appreciation meant that the internationally-exposed sectors of the economy, including large parts of manufacturing industry, were now suddenly confronted with much harsher trading conditions. That, as I say, had a dampening

effect on the UK economy and on inflation. But we couldn't just rely on that to cool the economy for us. Clearly at some point the exchange rate would stop appreciating, and this external dampening effect would have worked its way through. In the meantime, we needed to slow the rate of growth of domestic demand sufficiently to avoid overheating in the economy as a whole. The strong exchange rate gave us somewhat more time than we would otherwise have had to bring about this domestic slowdown – it meant that monetary policy did not need to be tightened as aggressively as would have been necessary otherwise. But we could not avoid tightening policy altogether, even though we realised that this would be likely to increase the pressures on the internationally-exposed sectors, because in anything other than the short term that would have put the whole economy – including the internationally-exposed sectors we were trying to shelter – at risk of accelerating inflation. I would remind you that right up until the summer of last year we were seeing signs of increasing pressures in the labour market, even in the manufacturing sector – reflected in increasing skills shortages and recruitment difficulties, in the employment/unemployment data, and in gradually increasing pay settlements. The uncomfortable reality, as I've said very often before, is that monetary policy can only target the economy as a whole – it can't seek to protect individual firms, or sectors, or regions, however much we might wish it otherwise. That – as I've discovered – is not exactly a popular idea, but there's no question that that is the reality of it.

Over the past year the world – and I mean the world – has changed very substantially.

The exchange rate has, in fact, tended gradually to soften since last spring when the decision to go ahead with the euro was finally confirmed; but increasingly since the autumn the internationally-exposed sectors of the economy have been dealt a further massive blow as a result of global economic turbulence.

This started, in fact, with the financial disturbances in Asia in the latter half of 1997, but even as late as the beginning of last summer it seemed as if it might have only limited impact on the overall world economy. The IMF, for example, was then still projecting 3-3¾% world growth in 1998 and 1999 respectively, which was certainly a setback compared with their forecast of over 4% just six months before, but it was hardly catastrophic.

Since last summer it has become increasingly clear that things are likely to be significantly worse than that. The financial collapse in Russia, deepening recession in Japan, the long battle – then sudden defeat – in Brazil to hold its exchange rate, and fluctuating fears of possible knock-on effects on the major countries' financial markets, all contributed to an increased sense of financial fragility, which has not been easy to contain, though I am now hopeful that we will be able to stop the financial rot.

But even if we can – and the financial markets' response to the latest developments in Brazil, as well as the beginnings of a recovery in capital flows to some countries in Asia, are reasonably encouraging in this respect – we are now having to cope with the economic after-effects of these earlier financial disturbances. The IMF has cut its most recent forecasts for world growth to close to 2%. And the risks almost certainly remain on the downside. That's still not global slump or recession. But large parts of the world economy are in fact in recession and the prospect for the world as a whole turns very much on what happens in the major industrial countries.

In essence, what we have seen is a brutally sharp cutback in capital flows to much of the emerging world and to some of the transition economies, creating a corresponding need for

urgent improvement in their current accounts. This has caused massive currency depreciations and forced the emerging countries to make equally sharp cutbacks in domestic demand. The counterpart is a sharp decline in net external demand in the industrial countries, which, if it were not to be offset by action to stimulate domestic demand in those countries, could indeed lead to weakening global activity and price deflation.

In fact to varying degrees, reflecting differing assessments of how far our particular currency areas are expected to be affected by the world slowdown and different starting points, relating both to our assessment of trends in domestic demand, and of how close we were initially to full capacity, both the UK and the Euro-zone, as well as the US, have acted fairly aggressively to reduce interest rates since the autumn; and Japan has moved to more active fiscal stimulus. And if the global economic prospect, and net external demand in the industrial countries, were to deteriorate further, then it would be right to contemplate further moves in the same direction – consistently with our aim of effective price stability. What we all aim to do – as I said earlier – is to keep aggregate demand in line with the supply capacity of our economies. We have no interest in the creation of unnecessary spare capacity in our economies as a whole, nor in a fall in the underlying general price level.

But that will still inevitably mean a sharp deterioration in the balance of payments of the industrial countries, collectively and probably individually, reflecting the imbalance between external and domestic demand growth in the industrial economies. And that in turn is bound to mean substantial pressure on the internationally-exposed sectors of the economy, not just in this country but throughout the industrial world, and we are already seeing ample evidence of that.

In the case of this country these adverse international influences really began to affect us just as overall demand was already weakening in response to the earlier monetary, and incidentally fiscal, tightening. The result was a very sharp decline in industrial – especially manufacturing – confidence, and widespread, and often exaggerated, fears of recession, which in turn appeared to undermine consumer confidence. The slowdown – or soft landing – we had been consciously seeking to engineer threatened quite rapidly to become a much sharper decline – or harder landing – than we had either expected or needed. And that, of course, is why we promptly changed our monetary policy stance as we did, cutting interest rates by 2% to 5½% in the space of five months.

In doing so, we have demonstrated that the inflation target is – as we have frequently said it is – symmetrical, so that we would be at least as determined and aggressive in cutting rates if we thought we were likely to undershoot the inflation target as we had been earlier in raising rates to avoid an overshoot of the inflation target.

So, where do we go from here?

I would strongly advise you to regard anyone who claims to know with any great certainty where we go from here with the gravest possible suspicion. Forecasting the economy is very definitely an art rather than a science – though some artists craft their work rather more carefully than others.

But, for what it is worth, the Monetary Policy Committee's view – described in considerable detail in our recent quarterly Inflation Report, which I can make available to you for a remarkably modest fee if you care to get in touch with me afterwards – is that while we will

not see much growth in the first half of this year – certainly in the internationally-exposed sectors of the economy – overall output growth will pick up on the back of stronger domestic demand as we move towards the Millennium to around trend or above from the second half of next year. We can't of course altogether rule out an actual downturn in total output over the next few months, though the odds are against that for the economy as a whole. And we are reasonably confident that the slowdown will be relatively mild and short-lived – certainly compared with equivalent periods in the past, for example at the beginning of the 1980's and 1990's. The good news is that we expect inflation to remain close to the Government's 2½% target over the next two years, which should allow the relatively steady growth we have seen in the overall economy since 1992 to resume on a sustainable basis.

Within this overall picture, we are still confronted with the difficult problem of imbalance between external and domestic demand and the sectoral and regional stresses that this implies. At some point, as global economic activity begins to recover, we will again need to act to restrain the growth of domestic demand, but that is a problem for the future.

Given the present international economic environment, and given the present advanced stage of our own economic cycle, if the outturn over the next couple of years is anything close to this – that is about the best we can realistically hope for.