Mr King speaks about interest rates, policy and the UK economy

Speech given by Mr Mervyn King, Deputy Governor of the Bank of England, to the Scottish Council Development and Industry, held in Edinburgh on 11 October 1999.

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1. Introduction

Twelve months or so ago, interest rates were 7½%; now they are 5¼%. Twelve weeks ago they were only 5%. So why do interest rates sometimes go down and sometimes go up? And why, in particular, did interest rates rise in September? At one level, the answer to these questions is straightforward: interest rates move – whether up or down – in order to keep inflation on track to hit the target of 2½%.

But, at a deeper level, why should monetary policy aim at a target for inflation rather than at growth and employment? Most people in this audience today belong to the "inflation generation". You will have lived through a time in which inflation was a fact of life. For much of UK history prices were relatively stable. But during the 1960s inflation started to rise. In the 1970s inflation averaged no less than 13% a year with a peak of over 27% in August 1975. During the following decade inflation averaged 7% a year, and it has fallen to around 4% in the 1990s. Between June 1997 – when the Monetary Policy Committee met for the first time – and August 1999 RPIX inflation averaged 2.6%. During that period, inflation has ranged from a low of 2.1% to a high of 3.2%. The experience of the past decade has been that low and stable inflation has gone hand in hand with more stable growth of output and employment. Total output in the economy has now increased for 28 consecutive quarters – an unprecedented period of positive growth. And unemployment, as measured by the Labour Force Survey, has fallen from a peak of 10.7% in 1993 to its current rate of 5.9%, the lowest level for nearly twenty years. The current outlook is for continued growth with low inflation.

If Britain is to retain this degree of macroeconomic stability, then there will be periods when interest rates will rise and periods when they will fall. For some commentators, interest rates can never be too low. But for too long there has been a view that interest rates should rise only when necessary, and should be lowered whenever possible. That asymmetric response was a recipe for instability.

The current monetary policy regime has been designed to lock in the greater stability of both inflation and output. There are three key elements in the regime. First, there is a clear and unambiguous objective for monetary policy – an inflation target of 2½% – set by the Government. Second, decisions on interest rates are taken each month by the Monetary Policy Committee (MPC) comprised of nine individuals with expertise in monetary policy – five executive members of the Bank and four non-executives – who operate on the basis of one person, one vote. There is, therefore, an appropriate division between the objectives of monetary policy, which are set by the democratically elected government, and the implementation of those objectives, which is delegated to a group chosen for their expertise. The third, and crucial, component of the regime is that the monetary policy process is characterised by a high degree of transparency and openness. Minutes of the MPC meetings are published within two weeks and the Bank's quarterly *Inflation Reports* contain the Committee's views on the outlook for inflation and output. It is important that the Monetary Policy Committee explain its decisions, not least to make future decisions as predictable as possible in the light of the evolving economic data.

Of course, it is always easier to explain policy when the decisions are popular. We have to redouble our efforts when decisions are less popular, and so I am delighted to have an opportunity this evening to explain and to listen. I shall leave plenty of time for questions because one of the purposes of visits such as these is to see things from *your* perspective. As Rabbie Burns wrote,

"O wad some Pow'r the giftie gie us
To see oursels as others see us!"

The real test of the MPC is whether it aims continuously to meet the inflation target. For that reason, the Monetary Policy Committee must be setting a policy for all seasons. Some of you may say that it is all very well to set a policy for all seasons, but what about a policy for all regions, or parts of the UK? Many critics disapproved of the recent increase in interest rates. Indeed, the Scottish Council Development and Industry (SCDI) itself described the decision as “disappointing”. It also described the rise as “premature”; we would describe it as pre-emptive: prompt action to head off inflationary pressures in the future and so lower the level at which interest rates might otherwise need to be set. The SCDI said that “Scottish business is regaining confidence after a tough period, but this announcement [of a rate rise] will dent that confidence”. Yes, it has been tough – indeed remains tough – for some industries, especially agriculture, tourism and parts of manufacturing. But there has not been an overall recession. GDP growth in the UK, over the previous twelve months, reached a trough of 1.3% in the first quarter of this year, and has been rising since then. With the new quarterly data, published by the Scottish Executive, it looks as though in the year to Q1 output growth in Scotland was higher than in the UK as a whole. The latest surveys show business confidence continuing to rise. And most welcome of all, unemployment has continued to fall in Scotland, as in most parts of the UK.

Nevertheless, the high level of sterling has undoubtedly caused serious problems for many sectors of the economy. As a result, some critics have argued that, with sterling at its present level, the burden of containing inflation should fall more on fiscal policy. By raising taxes or cutting expenditure this would, it is argued, enable the Monetary Policy Committee to lower interest rates, thus bringing down the pound. There is, it is alleged, a failure of coordination between monetary and fiscal policy. This argument deserves a reasoned answer.

So tonight I want to answer two questions. First, why did the MPC feel it necessary to raise interest rates in September, at a time when inflation was a little below target and might fall further in the next few months? Second, is there adequate coordination between monetary and fiscal policy under the new arrangements?

2. Setting interest rates to meet the inflation target

What a difference a year makes. Last October, bankers, especially in the United States, were talking about the worst financial crisis of their adult lifetimes. Reports from the Bank’s regional Agents indicated that business sentiment had deteriorated sharply, and the CBI October Industrial Trends Survey showed that optimism about business conditions among manufacturers fell to its lowest level since 1980. The possibility of a recession was widely discussed. The MPC responded to the change in sentiment and to worsening conditions in the world economy. It reduced interest rates by 2½ percentage points between October 1998 and June 1999. There has been a marked turn around in sentiment during this year. Confidence measures have returned to their pre-October 1998 levels.

This volatility in sentiment, is not reflected in the statistics on economic growth. The latest estimates of output for the UK show that over the past two years, output growth has been steady and close to trend with the exception of two quarters (1998 Q4 and 1999 Q1) during which a run down in stocks temporarily reduced growth. In part this stability was the result of pre-emptive monetary policy which, by reacting to the forward-looking information in surveys and other data, was able to offset the volatility in confidence feeding through to the real economy.

For sometime now, the high level of sterling together with falling world commodity and food prices have restrained retail price inflation. The prices of imports into the UK fell by 15% in the past four years. It is inevitable that this favourable impact on inflation can be only temporary. Only a further sharp rise in sterling, and further falls in commodity prices, could maintain these rates of decline of import prices and their benign effect on retail price inflation. And we see that these effects are now coming to an end. Import prices are beginning to rise, partly because of the recent rise in oil prices, but also because the rate of decline in other prices is slowing with sterling no longer appreciating as fast as it was.

It was possible to allow domestic spending in the economy to grow rapidly in recent years because the appreciation of sterling led to weak net trade. In real terms, the deficit in trade of goods and services has deteriorated sharply. But just as the one-off effects of lower import prices will not continue to hold down retail price inflation, so the rapid growth of domestic spending is itself unsustainable. In 1998 the increasing trade deficit reduced output growth by more than 2%. So modest output growth in the economy as a whole was consistent with rapid final domestic demand – that is spending by households, governments and business on consumption and investment. But the pace at which the trade position is deteriorating is itself now moderating, and final domestic demand grew at 4½% in the first half of 1999. So, even without any improvement in the trade deficit, the growth of final domestic demand will have to moderate to prevent GDP growth rising above trend and putting pressure on the supply capacity of the UK economy. Indeed, if the trade deficit is to be reduced, then domestic demand growth will have to fall below the growth of total output for a while.

So by the time of the September MPC meeting much had changed from earlier in the year. New data showed that final domestic demand was growing faster than expected. The data on the housing market – for the UK as a whole not just the South East – as well as credit indicated that the strong consumption growth over the past year might persist. And house prices, I should add, enter our decisions, because of their implications for future consumption, not because we are trying to target house or indeed any other asset prices. Unemployment was still falling: the Labour Force Survey measure of unemployment had reached its lowest rate since the series started, while the claimant count had fallen to its lowest level since 1980. The Bank's regional Agents had also noted tightness for both the skilled and unskilled. Oil prices had risen sharply during the year. These factors led a majority of the Committee to vote for a modest rise in interest rates of twenty-five basis points in order to keep inflation on track to meet the 2½% target.

The task now is to continue looking ahead. To do this the MPC has to assess the prospective balance between demand and supply in the economy as a whole. That requires an analysis of both demand *and* supply developments. The interesting feature of recent quarters has been the combination of strong demand growth and a tight labour market, on the one hand, with weak wage and price pressures, on the other. So the MPC monitors monetary data as well as signs of tightness in both labour and product markets in order to detect early warning signs of inflationary pressures.

The MPC needs as much timely and accurate information as possible. Official statistics and surveys provide an excellent starting point. But they often need to be complemented by more timely and focussed information on particular aspects of the economy. So the Bank has a network of twelve Agencies, which gather economic intelligence from all parts of the United Kingdom – from Cornwall to the Highlands, and from County Tyrone to the Norfolk Broads. The task of these Agencies is to provide information on the state of the local economy. In total, the Agents have around 7,000 business contacts covering all sectors of the economy from farming to finance and textiles to tourism. Our Scottish Agent, Janet Bulloch, who is with us tonight, is well known to many of you. I would like to thank those of you who give your valuable time to see Janet and her team. She and her staff see some 500 business contacts a year, and report the information gathered directly to the Monetary Policy Committee. In addition, members of the MPC themselves make regular visits to different parts of the country to listen and learn. And I shall be doing that during my visit to Scotland.

So whatever the critics may think, we are not short of information. Of course, whenever interest rates rise it is always said that the rise might be appropriate for certain parts of the country, but is wrong for some sectors of the economy, some regions or even some companies. The UK economy, we are reminded, is not homogeneous. Of course it isn't, and a good job too. But policy can never be set with the interests of one sector, or one region, let alone one company in mind. And it isn't. I can assure you that policy is not set with the South East of England in mind. But equally, it is not set either in the sole interest of the North East of England or Scotland. It is set for the United Kingdom as a whole.

Some have argued that if monetary policy has but a single instrument, namely the national interest rate, then would it not be sensible to use other policies to reduce imbalances in the economy? In particular, it has been suggested that fiscal policy should complement monetary policy in bringing demand into line with supply.

3. Coordination between monetary and fiscal policy

An occasional criticism of the new arrangements is that they impede proper coordination of monetary and fiscal policy. Two main reasons are usually advanced. First, the monetary and fiscal authorities may have conflicting objectives which they are free to pursue. Second, even if they have the same objectives they may be uncertain of each other's intentions. Neither concern is, I believe, well-founded. The first stems from a line of academic thinking which assumes that the central bank attaches more importance to the control of inflation than the Government, which in turn gives greater weight to output and employment. Hence when setting interest rates and fiscal policy, the two authorities could be pulling in opposite directions, and, realising this, might pull harder to offset the actions of the other, resulting in a distorted policy mix. Although such an outcome is possible in principle elsewhere, this problem does not arise in the UK. The reason is simple. The Chancellor sets the objectives for both fiscal *and* monetary policy. It is the Chancellor who sets the inflation target and then delegates the responsibility to achieving that to the Monetary Policy Committee. So no conflict arises.

Nor are the two authorities unaware of what the other is doing. A Treasury representative attends meetings of the MPC, and one of his duties is to brief the Committee on fiscal policy developments. This may take the form of advance notice of the overall fiscal stance to be announced in the Budget. Equally, he reports back to the Chancellor on the monetary policy decisions of the MPC. This clear, open and systematic line of communication works, if anything, better than the old practice where the markets would speculate on whether the government might "reward itself" by an interest rate cut if the Budget was well received.

But there is a further weakness in the proposition that monetary and fiscal policy are in some sense alternative instruments for influencing movements in aggregate demand over the cycle. There is a natural monthly cycle to monetary policy. Many of the relevant economic statistics are available monthly. But the natural cycle for fiscal policy is annual rather than monthly. It is costly to change taxes and government spending frequently. Changes in tax rates can distort the choices of the private sector and lead to a misallocation of resources. To raise and lower public spending at short notice can disrupt the provision of public services. And there are inevitable legislative and administrative lags in implementing quickly changes in tax rates and government spending. Tax rates and public expenditure should reflect long-run priorities of the elected government, and are not well suited to frequent changes. Since the MPC first met in June 1997, it has raised interest rates on six occasions, lowered them on seven occasions and left them unchanged sixteen times. It would make no sense for a government to try to change tax rates with that frequency.

For these reasons, fiscal policy is set so that the public finances follow a sustainable medium-term path. This commitment to budgetary prudence is enshrined into the net debt rule and the rule that public borrowing should finance investment and not current expenditure. In Hamlet, the advice of Polonius to his son was, "neither a borrower nor a lender be". If we update Shakespeare's dictum to "neither a borrower nor a lender be over the economic cycle except to finance public investment", then you have the spirit of the government's fiscal policy rules, if not the same elegance of language. So fiscal policy is set on an annual basis to maintain a sustainable path for the public finances in the medium-term. Monetary policy is set month-by-month to meet the inflation target. It is no part of the government's responsibility to make life easier for the MPC by manipulating fiscal policy to manage the economic cycle. What matters to the MPC is the overall fiscal stance, and that it remains on a sustainable basis. Decisions on that are made once a year in the Spring Budget. In the UK, coordination between monetary and fiscal policy works well.

4. Conclusions

In conclusion, therefore, I do not offer any simple solutions to the imbalances between different parts of the British economy. Fiscal policy is not an alternative to the month-by-month determination of monetary policy. And interest rates cannot target both inflation and asset prices, whether the exchange rate or share prices or house prices. Nor should they. Interest rates must focus on the economy-wide inflation target. But macroeconomic stability benefits all sectors of the economy. That stability, upon

which the aspirations of parliamentarians, both at Westminster and in Edinburgh, depend, is fundamental to the future prosperity of the United Kingdom. And to maintain stability, interest rates will sometimes go down and sometimes go up. For a quarter of a century, my generation – the inflation generation – suffered from the instability created by high and unpredictable inflation. To the next generation, I would like the Prime Minister, whoever he or she is at that point, to be able to say, "You've never had it so stable, not just for one year, or two years, or even three, but for a whole generation."

It is well known that many, if not most, of the great British economists were Scottish. One of the few English economists to rival the Scots was John Maynard Keynes. His view was that, "If economists could manage to get themselves thought of as humble, competent people, on a level with dentists, that would be splendid!". So perhaps the fate of the MPC is, rather like dentists, to perform an important service but one which does not make people happy. Regular monitoring and early treatment, while rarely pleasurable, prevent more unpleasant symptoms later. So it is with a pre-emptive monetary policy. As we said in our press release in September, an early move in interest rates "could lower the level at which interest rates might otherwise need to be set". That is why we raised interest rates last month and why the MPC is committed to the consistent pursuit of a symmetric inflation target.

But that is not all. The new monetary policy regime is probably the most transparent and open in the world. We are committed to explaining our policy – both to improve the efficiency of monetary policy itself and also to build up support for what we are doing. Try going onto the Bank of England's website – the address is www.bankofengland.co.uk – and you will find there the minutes of our meetings, as well as the Inflation Report, available to everyone. You will even find a copy of this speech. You may not always agree with our decisions, but I do hope you will understand the reasons for them.

Since the MPC was set up, there is, I think, a better understanding of what we are trying to achieve. Most of those who disagree with particular interest rate decisions accept that it does make sense to have an inflation target. Some might wish that we interpret the inflation target in a way that better serves the interest of their own sector of the economy, but that would be to court popularity in the short term at the expense of achieving low and stable inflation in the long term. We are committed to a dialogue, and that includes a dialogue with the people of Scotland. I cannot claim that we shall always do what some of you would like us to. But I can promise that we shall explain and we shall listen. And we shall remember those words of Rabbie Burns,

O wad some Pow'r the giftie gie us
To see oursels as others see us!
It wad frae mony a blunder free us,
And foolish notion.

Some of you may still feel that the MPC's decision to raise interest rates was a "foolish notion". But I can assure you that our mission to explain will continue, and that we shall take the case for stability to every part of the country in order "to see oursels as others see us".