Eddie George: Sterling strength, the euro and UK monetary policy

Speech by the Rt Hon Eddie George, Governor of the Bank of England, to the Leeds and Bradford Chartered Institute of Bankers and Bradford Chamber of Commerce, Bradford, on 11 April 2000.

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It’s a real pleasure to be here in Yorkshire and I am greatly honoured to have this opportunity to speak to such a large and distinguished audience. I am honoured - but also, I must confess, somewhat daunted. I am acutely aware of the fact that, while there are some parts of the region that are - economically - doing extremely well, other parts, particularly those most exposed to international competition, are under the hammer. That’s true of course of the UK economy as a whole. I’m equally aware that the suffering sectors ascribe their pain to the strength of sterling, particularly against the euro, which is certainly a contributory factor; and that they ascribe the strength of the exchange rate to our domestic monetary policy and to the Monetary Policy Committee.

I should like to address some of these concerns this evening and then go on to say a few words about the great euro debate.

Let me begin with some comments on the very profound changes that have occurred, gradually over a long period, in the approach to economic management in the UK and in our more recent economic performance.

For most of the first half of my own working life - through the 1960s and much of the 1970s - the essential emphasis of economic management in the UK was on short-term aggregate demand management, with too little regard to the structural, supply-side capacity of the economy to meet that demand. Monetary and fiscal policy were used in combination to try to maintain an appropriate balance between what were seen as conflicting objectives of growth and full employment on the one hand and price stability and balance of payments equilibrium on the other. Slow growth and high unemployment were typically met with monetary and fiscal stimulus. As the symptoms of imbalance inevitably emerged - in the form of external deficits or accelerating inflation - attempts were made initially to suppress those symptoms through various forms of direct control (for example, foreign exchange controls or credit ceilings or prices and income policies) but as demand pressures built up macroeconomic policies had eventually to be thrown sharply into reverse. This was the go-stop policy cycle that resulted in the exaggerated boom-bust economic cycle, which was for a long time a pronounced characteristic of British economic performance.

Such macroeconomic instability was disruptive in itself, but it also had the effect of encouraging short-term attitudes to both financial and non-financial investment, with a corrosive effect on our longer-term, supply-side capacity. And the pressures within the economy threatened to become explosive, in that the rate of inflation increased from cyclical peak to cyclical peak, while the rate of unemployment increased from trough to trough.

Over time we learned many lessons from this experience.

We learned first the importance of macroeconomic stability. We came to understand that there is in fact no trade-off - in anything other than the short term - and not necessarily even then - between growth and stability.

Emphasis on short-term demand management gave way to emphasis on the creation of a stable longer-term economic environment, within which the private sector could operate more efficiently and plan with greater confidence for the future.

In terms of fiscal policy, this meant a medium-term framework, with tighter control over public expenditure, to ease the tax burden on the private sector and to limit the overall deficit and debt burden to a sustainable level at which it did not pre-empt national saving and deter private investment.

And monetary policy - which is inherently more flexible - was assigned the particular role of providing a stable nominal framework for economic decision-taking, with the immediate aim of permanent effective price stability but as a means to the end of sustainable growth rather than as an end in itself.

But we also learned to pay more attention to the structural, supply-side capacity of the economy and in particular to the role of reform - and deregulation, subject to appropriate safeguards, of goods, capital and labour markets, as the means of increasing the economy's flexibility and the underlying rate of growth that can be sustained.

We learned finally that these twin approaches - of macroeconomic stability and supply-side reform - reinforce each other.

It is these understandings that lie at the heart of our present economic policy framework.

On the macroeconomic side, the Government has enacted legislation which requires it to set out transparent rules for fiscal policy. For the current Parliament it has chosen to adopt two specific rules.

First, over the economic cycle, Government borrowing will be restricted to borrowing for investment, and not to fund current spending; and

Secondly, net public debt as a proportion of GDP will be kept at a prudent and stable level over the economic cycle.

These rules taken together are designed to ensure financial stability in the medium-term, but also allow for automatic stabilisation in response to fluctuations in output growth in the short-term.

On the monetary side, the Government has set a low, symmetrical target for underlying retail price inflation as the objective of monetary policy; and it has devolved technical responsibility for setting short-term interest rates to achieve that objective - on average over time - to the Monetary Policy Committee of the Bank of England. Its members, individually and collectively, are publicly accountable for the way in which that responsibility is exercised.

The supply-side agenda, under successive governments has inevitably been more diverse.

It has included a strong commitment to free markets and competition as the motive forces for productive efficiency, and as the essential means of allocating financial and real resources. It includes an equally strong parallel commitment - both regionally within the European Union but also more broadly - to international free trade in goods and services and to the global free flow of capital.

The supply-side agenda has included an extensive program of "privatisation", bringing market disciplines to bear on commercial activities previously undertaken within the public sector, but often involving new forms of regulation in areas of activity that might otherwise be dominated by natural monopolies.

It has included extensive deregulation - for example in relation to financial services, including banks and building societies, though this has been accompanied by improvements in the financial infrastructure and by enhanced prudential supervision.

It has included measures of labour market deregulation and Trade Union reform. And it has included increased emphasis on education and training; measures to encourage business enterprise - especially among smaller businesses; and reforms to the welfare system to improve incentives to work. The list could go on.

The point is that there has been increasing recognition that it is the complex interaction of policies across the board - often involving difficult political judgements as to how best to reconcile economic and other social objectives - that influences the supply-side capacity of the economy. And it is that which determines the underlying rate of growth that can be sustained and sets the limits to what can be achieved through macroeconomic demand management.

Against that background our recent economic performance has improved. In fact, since the broad monetary policy framework of inflation targeting was adopted in the UK some seven years ago, the United Kingdom as a whole has in fact achieved the longest period of sustained low inflation we've known for a generation. Retail price inflation, on the Government's target measure, has averaged around 2.7%.

But alongside low inflation we've had the lowest nominal interest rates that most of us can remember. Short-term rates have averaged some 6¼% compared with some 11¼% over the preceding decade. And 10-year government bond yields have fallen, with inflationary expectations, to around 5¼% which apart from a brief period last year is the lowest they've been for nearly 40 years.

Much more fundamentally we've enjoyed the longest period of uninterrupted, quarter by quarter, economic growth since records began some 45 years ago - with annual growth averaging 2.8% - between ¼ and ½% above most estimates of our underlying trend rate. The number of people in employment is the highest on record. And unemployment has fallen from a peak of 10½% on a claimant count basis at the beginning of 1993 to the present rate of 4%. That is the lowest for 20 years in the UK as a whole, and just about the lowest in nearly every region. In Yorkshire and Humberside unemployment is 4.7%, the lowest rate since June 1980.

Our problem - and it is a real problem, as we have recognised for some time - is the imbalance, within the overall economy, between the domestically-oriented businesses and sectors, and those that are most internationally exposed. In part that imbalance is a hangover from the slowdown in global activity from the end of 1997 through to the start of 1999 - though the welcome recovery in global demand means that this influence is now diminishing. The more important factor now is the persistent weakness of the euro - not exclusively against sterling but equally against the dollar and the yen. The impact is particularly severe on the UK because of the closer ties between our economy and that of the Eurozone.

I've not heard a wholly convincing explanation for the euro's persistent weakness. Many analysts relate it to market concerns about structural rigidities in some parts of the Eurozone, which are encouraging direct capital outflows attracted elsewhere by higher prospective earnings growth.

Whatever the cause, few of those I talk to expect the weakness of the euro to persist. But in the meantime, given that the problem is driven by perceptions of the eurozone, rather than any particular strength of sterling, it is very difficult to see what we in the UK can do directly to resolve it.

The weak euro affects us at the macroeconomic level in two ways: it has a dampening effect on our price level; and it reduces net external demand on our economy. To offset these influences - to prevent overall demand growth falling short of underlying capacity growth, causing inflation to fall significantly below our 2½% target - and I remind you it is a symmetrical target - we have had to keep interest rates lower than would otherwise have been necessary, in effect encouraging stronger domestic demand growth, to keep the economy as a whole on track. The risk in this approach, of course, is that we could find it difficult to moderate the pace of domestic demand growth to a sustainable rate as and when the euro recovers. But that's a bridge we will need to cross when we get there.

Now some of you involved in those sectors that are suffering most from the weakness of the euro would - from your own perspective - like us to go further and try more actively to drive the exchange rate down. If I were in your shoes, I'd be tempted to argue that myself. Euphemistically it is suggested that we should "pay more attention to the exchange rate" - than, as I've explained, we do already. In practice what that would be likely to mean in our present situation is substantially lower interest rates: the intended effect would be to stimulate external demand, but it would inevitably also involve further stimulus to domestic demand. In effect, it implies that we should acquiesce in increasing overall demand pressure leading inevitably to faster inflation. That might conceivably even provide some relief to the suffering sectors in the short term. But increasing demand pressure, including labour market pressure, and accelerating inflation would - as we've repeatedly seen in the past - ultimately need to be brought back under control, involving a more abrupt tightening of policy. That frankly would not do the suffering sectors themselves much good at least for very long - and it would have a potentially serious destabilising effect on the economy as a whole. That is precisely what we are trying to avoid.

The more hopeful news is that we have recently seen strong signs of recovery - of both economic activity and exchange rates - in a number of emerging markets and transition economies. And we are seeing a strengthening of domestic demand and of output in the Eurozone, which may help the euro to appreciate. To the extent that these trends persist, it will help to ease the exceptional pressures on the most internationally-exposed sectors, and contribute to a better balance within the UK economy. But it will need to be accompanied by corresponding moderation of the growth of domestic demand - after the offsetting stimulus of a year ago - if we are to maintain overall stability. That essentially is why interest rates in the UK have had to rise since last autumn.

We are now in a position where the economy as a whole is again growing above trend - after a pause a year or so ago - while inflation is running - and has been running for nearly a year - slightly below the Government’s 2½% target.

Looking ahead, there is the tantalising prospect of new factors that might help to hold the rate of inflation down, at least in the short term. There is evidence for example, although it is hard to evaluate, of more intensive retail price competition, squeezing retail margins across the board, and that could hold down prices, at least for a time. And this effect could intensify and extend further into the future as a result of the spread of e-commerce. And there is, on the supply-side of the economy, the possibility (though so far sadly not much actual statistical evidence) that the spread of IT will accelerate productivity growth across the economy - as it has in the United States, raising the underlying rate of potential output growth at least for a time.

We certainly have not closed our minds to the possibility that these developments might allow us to sustain for a time stronger growth consistently with meeting our inflation target. But we can’t afford to gamble on that outcome either. The truth is that the jury is still out. What we have to do is to monitor intensively all of the data as it becomes available to us, and draw what inferences we can as to how those data affect the balance of risks around the inflation target looking ahead.

What is encouraging, Mr Chairman, is that for all these uncertainties and complications the broad prospect for the UK economy as a whole over the next couple of years is for continuing relatively strong growth - at or above trend - with continuing relatively high employment, and continuing relatively low inflation. The monetary policy debate in the UK is a narrow one, it is about just how strong the growth, just how high the employment and just how low the rate of inflation.

Against that background, let me finally say a few words about UK membership of the euro.

Let me make clear, from the outset, that monetary union is fundamentally a political rather than an economic issue. It necessarily involves the deliberate pooling of national sovereignty over important aspects of public policy, in the interest not just of collective economic advantage, but of a perceived wider political harmony within Europe.

As a central banker, I have nothing to say about the politics of monetary union - that’s for elected politicians. But it is also an economic issue and that is my concern.

So what are the economic pros and cons?

The potential economic advantages and disadvantages are now reasonably well defined - though different opinions inevitably attach different weights to the respective arguments.

On the plus side, the crucial and unique economic advantage of monetary union is nominal exchange rate certainty within the Eurozone - which takes over half UK exports. I’m not talking just about reasonable exchange rate stability - which might result over time from each country pursuing disciplined macroeconomic policies in parallel. I’m talking about nominal exchange rate certainty for the indefinite future.

That very real economic advantage is well understood in the UK - especially by businesses that trade with, or compete with, businesses in the Eurozone. And on that ground alone many of them, who have suffered from excessive sterling strength against the euro, would see our joining as an advantage provided of course the exchange rate were initially fixed at an appropriate - and significantly lower - level than at present. At the broader macroeconomic level the potential benefit of joining - as a result of greater transparency of costs and prices and lower transaction costs - leading to greater competition and more efficient economic resource allocation is well understood.

Exchange rate certainty within Europe - even though it is nominal certainty rather than real exchange rate certainty - would potentially enhance the benefits to be derived from the European Single Market.

The euro’s second very powerful advantage is the possibility it opens up for much broader and more liquid financial markets. It will mean a progressive narrowing of spreads between borrowers and lenders - and that will be good news too for financial intermediaries as a group, because it will lead to higher volumes of financial activity - though not every individual intermediary will benefit, of course, in the more competitive environment. The City of London is already making an important contribution to this process of financial euro-market integration.

So there are potentially powerful advantages. What then are the risks - the possible arguments against our joining the euro?

Essentially the potential downside can be summed up as the risk that the single - one-size-fits-all – short-term interest rate within the Eurozone - which is the inevitable consequence of a single currency - will not in the event prove to be appropriate to the domestic monetary policy needs of all the participating countries.

Countries may have divergent cyclical positions. They may face divergent fiscal positions which would affect their appropriate fiscal/monetary policy mix in different directions - though this should be contained by the Growth and Stability pact. Or their domestic policy needs may diverge as a result of economic shocks of some sort - a classic but unique example being German unification, but the recent global economic disturbance is perhaps another example.

So the risks of divergent monetary policy needs within the monetary union are real. They are essentially similar to the risks of sectoral and regional divergences within a national currency area. And if there were to be material divergence within the Eurozone the tensions could be more severe than in a national currency area because alternative mechanisms - labour migration or fiscal redistribution through a central budget - which help alleviate regional disparities in the national context - are less well developed at the Eurozone level.

Some commentators point to the present inflationary pressures in Ireland as an example of the problems that could arise on the upside as it were - through I’m not sure how far one can generalise from the Irish case.

The fact that the UK did not join in the first wave of EMU was a disappointment to some people, including to some of our European partners - but it was also a considerable relief to them - we could have been the elephant in the rowing boat! It was I must confess also a relief to me. If we had joined EMU from the start - and had Eurozone interest rates over the past year or so it is very difficult to envisage how we would have avoided an inflationary boom in this country. It is true that, to the extent that the present imbalance within the economy reflects sterling’s appreciation against the euro, we would have been protected against that. But, with accelerating inflation in the economy as a whole, the price of such protection of the suffering sectors would have been tantamount to real exchange rate appreciation, which would in any event have damaged their competitive position. And, it would not in that case be possible to reverse that effect through exchange rate adjustment. Joining EMU from the start would in fact, as things have turned out, have been a strong form of relaxing our objective for consistently low inflation in the economy as a whole to ease the pressures on the internationally-exposed sectors which I argued against a few moments ago. There are no easy answers so long as our economies continue to diverge.

Coping with such tensions as may emerge within the Eurozone - with or without the UK - is likely to be easier in a context of structural, supply-side flexibility and adaptability - which also, as I say, essentially determines the underlying rate at which the economy can expand in the medium and longer-term. The Eurozone started with chronically high unemployment. Some countries still have very high ratios of public debt to GDP. And most face the prospect of an increasing burden on their public finances with ageing populations.

Some people in the Eurozone acknowledge these concerns, but they are inclined to argue that if a country participating in the monetary union were to find itself in an unsustainable situation and given that it would have no macroeconomic way out - through exchange rate adjustment, or independent monetary policy action, or fiscal stimulus beyond the limits of the Growth and Stability pact - and given limited labour migration or fiscal redistribution at the pan-European level - then it would have an overwhelming incentive to undertake the supply-side reforms which have proved so difficult to introduce up until now. One of my ECB colleagues in fact once put it to me that - “when we have closed off every other policy option, we will finally be forced to do the things we know that we should have done all along!”

I hope that this proves to be right and that it does help ease the tensions. Supply-side flexibility within Europe is crucial in my view not just to the success of the euro, but to the success of the European economy in a much broader sense - to the resolution of Europe’s chronic unemployment problem and to the contribution which a strong European economy can make to the whole of the world economy.

In all of this - in our pursuit of both macroeconomic stability on the one hand and structural reform on the other - we share much the same basic philosophy as our partners in the European Union, though it may be true to say that, at least as a matter of degree, while we were later than some of them in coming to macroeconomic stability, we may have gone further in the direction of improving the supply-side flexibility of our economy through structural reform.

The best thing that we can do for the time being - on both sides - is to pursue this common approach in parallel. That should help to bring about greater convergence between us, to reduce the risks of UK membership of the euro and to help meet the Government’s five economic tests for joining. In the meantime, ahead of any decision, it seems sensible to prepare in order to keep open the option to join.