# Ian Plenderleith: Current issues in UK monetary policy

Speech by Mr Ian Plenderleith, an Executive Director of the Bank of England, to the Aberdeen Chamber of Commerce on 26 July 2000.

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If you look at the performance of the UK economy as a whole, there is a great deal from which we can draw encouragement. Since the early 1990s, we have enjoyed what by any standards has been an impressive period of continued growth in output, employment and living standards.

The sustained growth in output has been achieved despite the downturn in Asia in 1997-98, which, accentuated by the crisis in Russia, spread to the emerging market economies as a whole and produced a sharp weakening in external demand felt by all the industrialised countries. With the help of the rapid steps we took then to cut interest rates, we have seen a strong recovery in activity in the UK economy last year and continuing growth this year.

Equally, we can draw encouragement from the steady rise in employment that has accompanied this sustained growth in output. The improvement has been shared right across the UK: rates of employment vary from region to region, but all regions have shared a rise in employment rates. What is particularly encouraging is that this substantial rise in employment rates has been achieved in the face of considerable changes in the business environment - for example, shifts in demand and in consumer taste, advances in technology and intensified competition. Industry and commerce has proved extremely effective in creating new jobs to offset, and more than offset, jobs lost as the business environment has changed.

What is particularly notable about this impressive growth in output and employment is that it has been sustained over a period of years and, importantly, there is every prospect that we can continue to sustain it looking ahead. This element of sustainability is, above all, what translates periods of strong output and rising employment into permanent improvements in living standards. Sustainability means having in place a framework to provide a basis of stability on which the economy can continue to grow. Alongside the stable framework the government has put in place for fiscal policy, the Bank of England’s contribution to stability is to deliver price stability - specifically, to meet the low inflation target the government has set of 2½% on the RPIX. Perhaps the most encouraging feature of the strong economic performance I have described is that it has been achieved consistently with low inflation, and it is through maintaining that commitment to low inflation that we can best ensure that the economy continues to grow over time in line with its potential.

Against the background of this encouraging overall picture, we face two main areas of uncertainty at present.

The first is the impact of the strong exchange rate for sterling. The strength of sterling in recent years has impacted on virtually all areas of the economy - agriculture and some service industries as much as manufacturing. But the effects have undoubtedly been felt most severely by manufacturing. The frustration felt by those who have built up efficient and competitive businesses, only to find their market position threatened by a rise in the exchange rate over which they have no control, is entirely understandable. In our judgments on interest rates, we consider it extremely important to take account of differences in the conditions that different sectors of the economy, and different regions of the country, may be facing. For that reason, our 12 Agents, located around the country, keep closely in touch with local business and provide us with a continuous and very up-to-date feedback on local business conditions. Visits like my own today provide valuable opportunities for MPC members to supplement at first hand the feedback we get from our Agents. The message we get - that the rise in sterling has been, and is, causing severe strains, comes through loud and clear and we give that considerable weight in our judgments about interest rates.

The difficulty we face is that, while some part of sterling's rise in the past few years probably reflects underlying strengths in the UK economy - the sustained growth in activity in recent years and the more flexible and competitive structure of the economy - it is very likely that sterling at its present levels is unrealistically high, and that this is principally a reflection of the persistent weakness of the euro over the past year or so rather than factors directly related to sterling. To compound the difficulty, it is in fact very hard to see why the euro has remained relatively weak at a time when growth in the euro-area economies as a whole has recovered strongly. For the moment, in judging the appropriate level of interest rates, we take very carefully into account the weakness of the UK's external sector, and the impact particularly on manufacturing, as an immediate factor off-setting in part the buoyancy of domestic demand. But we also have to take into account the possibility further ahead that, if the exchange rate moves back to more realistic levels, as we expect, the boost that could bring to external demand could only be accommodated, without strain on the supply capacity of the economy as a whole, if domestic demand has moderated. Looking ahead, given that it is hard to explain the relative weakness of the euro, it is reasonable to expect that it may in due course recover to more realistic levels; and there has indeed been some welcome movement in that direction since the spring. Whether that will continue is hard to judge, but it would be enormously helpful both to the balance of the UK economy as a whole and to the individual businesses most directly affected.

The other major area of uncertainty we face is the encouraging and exciting, if somewhat tantalising, prospect that the UK may come to enjoy, or indeed may already be beginning to enjoy, some of the benefits evident in the US arising from the "new economy". The advances we are seeing in information and computer technology, when combined with the greater flexibility and adaptability our economy has shown in recent years and the wider trading opportunities and greater competitiveness flowing from the globalisation of the world economy, are potentially very exciting because they represent scope for improvements in the supply side of the economy: they hold out the possibility that the economy might be able to grow faster than recent historical experience without jeopardising price stability. The dilemma is that, while the benefits these developments can bring are undoubted, if and when they manifest themselves in enhanced economic performance, the evidence of their doing so in the UK is, so far, piecemeal rather than conclusive. Assessing whether these developments are in fact delivering concrete gains requires cool heads and careful judgment. My own view is one of pragmatic optimism. There are promising portents, but relatively little concrete evidence as yet, of the UK achieving the improvements in productivity that have so benefited the US economy in recent years. That does not mean that it will not happen here. But it does mean that we need to be both vigilant to avoid the pitfall of anticipating the gains before they arrive, and alert to capitalising on them if and when they begin to come through.

Overall, then, the prospect we face is an immensely encouraging one. We need to remain vigilant, but, provided we take no risks with the progress we have made in recent years in maintaining low inflation, the prospect is for continuing growth overall on a basis that can be sustained into the medium term. For the Bank of England, our first, and continuing priority, has to be to continue to deliver the stable monetary framework - of interest rates directed at maintaining low inflation - as a platform on which commerce and industry throughout the country can continue to build their business and generate the sustained growth in output and employment that will provide permanent improvements in living standards.