

The Rt Hon Sir Edward George GBE: What the Bank of England is trying to do through the Monetary Policy Committee in its conduct of monetary policy

Speech by The Rt Hon Sir Edward George GBE, Governor of the Bank of England, at the Yorkshire Forward/Bank of England Regional Dinner, for Yorkshire and the Humber Business and Civic Leaders and MPs, held in Sheffield on 16 January 2001.

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Mr Chairman, I am delighted to join with you in welcoming everyone to dinner this evening here in Sheffield, and I should like to begin by thanking you, Master Cutler, for allowing us to host the event here in the Cutlers' Hall. I have had the pleasure of speaking here before – some five years ago, at the Cutlers Feast – and it is indeed a privilege which we greatly appreciate. Thank you.

Since then, of course, the Bank of England has been subject to new legislation. The new Bank of England Act confers upon us – specifically upon the newly-created Monetary Policy Committee – independent responsibility for the conduct of monetary policy; but it also expanded and increased the role of our Court of Directors, including giving an oversight responsibility to the Non-Executive Members of Court to ensure that the Monetary Policy Committee has collected the regional, sectoral and other information necessary for the purposes of formulating monetary policy. These changes, inter alia, have made the Bank especially conscious of the importance of its regional presence. As you know, we have a branch office up here in Yorkshire, in fact in Leeds, which serves as a part of our network of eyes and ears and indeed voices at 13 locations throughout the UK. The new responsibility made us more conscious than ever of the importance also of visits around the country by senior members of the Bank in London, including members of the MPC and indeed our Directors, both to inform themselves about local economic conditions and to explain locally what it is that we are trying to do. That explains why you have been seeing much more of us in recent years and it explains in particular tonight's invasion of Yorkshire, by 11 of our 16 Directors and 6 of the 9 members of the MPC. Tomorrow in Leeds will in fact be the third occasion on which our Court has held one of its monthly meetings outside London since the new legislation was introduced in 1998, a practice which we intend to continue.

So that I hope explains why we are here – and I hope that you will avail yourselves of the opportunity to bend the ears of our representatives where you can – but preferably not until I've finished speaking to you! For my purpose tonight is to explain what it is that the Bank through the MPC is trying to do in its conduct of monetary policy, to say something about where we are and to explain some of the risks and uncertainties that we are facing as we look forward.

What then are we trying to do? The MPC's mandate from the Government is to maintain price stability (currently defined as an inflation rate of 2½% - on a specific measure of retail price inflation) and subject to that to support the Government's economic policies, including its objectives for growth and employment. Now no-one can reasonably suppose that inflation could be held precisely at 2½% consistently over time. But we are consistently to aim at that target. Now what that involves essentially is trying to keep aggregate nominal demand in the economy more or less continuously in line with the overall supply-side capacity of the economy – as a whole – to meet that demand. In fact, although our objective is defined narrowly in terms of price stability – the 2½% target – we can only hope to achieve it by maintaining stability in a much broader sense – that is by consistently maintaining a balance between overall demand and supply. That, essentially, is how best we can contribute to the Government's objectives for growth and employment.

It is in fact a necessary condition for maintaining the steady economic progress that we have seen in recent years.

There is not a great deal that we can do – through monetary policy – directly to affect the supply-side of the economy, the underlying rate of growth that we can hope to sustain. Maintaining a stable monetary environment can certainly help, but that is essentially determined by the ingenuity and skills of our business managers and our workforce, by the whole range of Government policies and importantly too, Mr Chairman, by the imagination, energy and enthusiasm of organisations like your own Yorkshire Forward in developing and putting into effect your Regional Economic Strategy. Our job – as I say – is to keep overall demand in the economy growing broadly in line with supply-side capacity.

So how then are we doing?

First on inflation. Since we came out of the last recession, in 1992, retail price inflation (on the Government's target measure) has averaged 2.7%; it has in fact been marginally below the 2½% target for much of the past two years and was 2.0% in the latest 12 months to December. Short-term interest rates - which went up to 12% (and tentatively even to 15%) before we left the ERM in 1992 have been stable at 6% for the best part of a year. Helped by a decline in inflationary expectations, UK 10 year Government bond yields have fallen to around 4¾% which, apart from a brief period at the beginning of 1999, is the lowest they've been for nearly 40 years. They are now just about as low as in any major industrial country with the exception of Japan.

At the same time our economy has now grown continuously quarter by quarter for over 8½ years at an average annual rate of 3%, which is well above most estimates – at least until recently – of a longer term trend rate of 2¼-2½%.

And the number of people in work has recently been at an all-time high in the UK as a whole, and close to its high point in your own region; while the rate of unemployment, on a claimant count basis, is at a 25 year low in the UK as a whole and at its lowest for 20 years in Yorkshire and Humberside.

The question now of course is – can we keep it up?

The answer to that question depends on developments both at home and abroad, but let me comment first on the international situation which is currently the focus of a great deal of attention.

As I explained in a speech last night in Edinburgh, the bounce back from the world economic slowdown in 1998/1999 was such that in the year just ended world economic activity grew at a rate of some 4½% which equals the fastest rate for 16 years – and compares with an average rate of some 3¼% over the last 10 or 20 years. In large part this recovery was underpinned by unusually strong growth in the US, averaging some 4½% over the past 4 years and surging to a peak of some 5½% at an annual rate in the first half of last year – compared with an average rate of 2¾% over the preceding decade. This remarkable strength of the US economy was possible, without overheating, against the background of unusually rapid productivity growth as investment in IT spread through the US economy improving its supply-side capacity. These developments together implied higher corporate earnings growth in the US pushing up the stock market and at the same time attracting massive direct and portfolio capital inflows into the US – substantially from the Eurozone – which comfortably over-financed a burgeoning US current account deficit and underpinned the strong dollar.

However helpful all this was in supporting the world economy it clearly could not continue for ever or without limit. At some point – and no-one could know at all precisely at what point – demand in the US would begin to outstrip supply and the growing external imbalance between the US and the rest of the world would become unsustainable; relative asset prices – including the dollar's exchange rate – would over-discount prospective US corporate earnings growth and both equity and foreign exchange markets would then become vulnerable to abrupt correction.

Against that background it has been clear for some time that there needed to be a slowdown in the growth of the US economy to a rate which was more sustainable, both in the US itself but also in terms of the imbalance within the global economy – and the debate turned to whether it would come as the “soft landing” we would all welcome or a more disruptive “hard landing” which we could all well do without.

And slowdown, of course, is what we have seen over the past six months. In the third quarter US GDP growth fell to an annualised rate of some 2¼% - less than half that in the earlier part of last year, and much of the more recent data suggest a further weakening. This slowdown has been reflected in a fall in equity prices – including a sharp fall in the previously hugely overblown “tech-heavy” NASDAQ index; and this in turn has contributed to a typically rapid escalation in the language of commentators, from slowdown, to imminent downturn or recession, to possible slump.

Of course it is always possible that it will come to this – no-one has a crystal ball – and it goes without saying that we are all watching what's happening very carefully. But that is not my own view of the most likely outcome, nor that of my central bank colleagues from around the world when we met in Basel a week ago. We met in the wake of the Fed's move to cut interest rates which was widely welcomed as timely and appropriate, demonstrating sensitivity to the possibility of a spiralling decline in financial market and business and consumer confidence. We noted, too, that in announcing its move the Fed had made a point of emphasising its expectation of continuing relatively strong productivity growth, giving it more room for manoeuvre than it would otherwise have. Against that

background, the view was that, while the US economy might be in for a bumpy ride over the next few months, associated for example with inventory adjustment in the motor industry, the likely outcome for this year as a whole is that the US economy will continue to grow, by perhaps 2-3%, and that the overall world economy – helped by steady growth in the Eurozone – would again this year grow probably at somewhat above its longer-term average rate. That, certainly, is a slowdown in the recent rate of growth – and a downward revision of earlier expectations of growth for the current year; but it is not a downturn in the sense of contracting activity. On this view, the slowdown in prospect would have relatively benign effects in terms of the longer term sustainability of the global economic expansion; and developments so far have already had positive effects both in terms of their impact on the world oil price, and in terms of their impact on the pattern of exchange rates, notably by reducing the exaggerated weakness of the euro.

On that basis the global economic environment should provide a reasonable background for our own economy. We – and our partners in the European Union – would be relatively little affected by the US economic slowdown. The world economy as a whole would certainly be helped by the somewhat softer oil price. And the recovery of the euro – including its recovery against sterling – will help to ease the severe imbalance within our own economy between the domestically-orientated sectors which have typically been doing relatively well and those businesses and sectors that are most exposed to competition from the Eurozone and which have been having a rough time. That imbalance is, I know, a real concern to many up here in Yorkshire, including many of you here in Sheffield. It has, for some time, been one of the most difficult issues confronting us in conducting monetary policy.

What then are the major domestic uncertainties? There are really three key areas:

- First, there is uncertainty about what in fact is happening on the supply-side of the economy, that's to say how rapidly can aggregate demand be allowed to increase before it begins to run ahead of supply and put upward pressure on inflation or, alternatively how rapidly must demand increase in order not to run below supply-side capacity and cause inflation to fall significantly short of the inflation target. The target is, of course, symmetrical;
- Secondly, and specifically in relation to the labour market, at what point does the growth of employment or the fall in unemployment lead to a rate of increase in pay settlements, or earnings growth, which would subsequently lead to accelerating inflation in goods and services markets; and
- Thirdly, what is happening or is likely to happen to the rate of growth of aggregate demand in the economy anyway.

Now, as I said earlier, there is not a great deal that we – through monetary policy – can do directly to affect the first two of these areas of uncertainty, which relate to the supply-side of the economy. The major challenge for us in these areas is in assessing – or quantifying – their impact. And that's not at all easy because, while the effects gradually become apparent over time, many of the relevant developments cannot be directly observed or measured; nor therefore can they be predicted with any great confidence. But we are sensitive to the fact that certainly over the past two or three years price pressures in both product and labour markets have been less than we would have expected based on earlier experience, given the strength of demand. You might explain this in terms of more intense competition and lower margins in product markets; or in terms of an increase in the rate of productivity growth, perhaps related to the application of new technology, such as we have seen in the US; and you might explain the recent relatively benign real earnings growth in terms of the more flexible functioning of labour markets. But we cannot be sure of the explanation, nor of how large or persistent the relevant effects will prove to be. We are nevertheless sensitive to these possibilities; we do indeed try to allow for them in our forecasts and in our policy judgements, based upon careful scrutiny of all the latest information that we have. But the process remains necessarily judgmental, and that, of course, leaves us vulnerable to assertions that we don't give sufficient weight to this or that factor. That, some of our critics maintain is why inflation has been below target for much of the past two years. In fact the undershoot has been marginal – given the uncertainties - and can just as well be explained by the unexpected strength of sterling's effective exchange rate, reflecting the weakness of the euro, which has both directly dampened the price level and constrained external demand.

We, of course, can and do actually affect the third main area of uncertainty – the nominal demand side of the economy – by setting short-term interest rates. But here, too, we have to rely to a considerable extent upon judgement, given the uncertainties

- about what is currently happening to demand, given the lags and contradictions in the data and the fact that they are in many cases subject to later revision;
- about the strength and persistence of the underlying forces driving demand looking ahead; and
- about the sensitivity of the various components of demand to changes in the level of interest rates.

It can't be said too often that the operation of monetary policy is an art rather than a precise science, although practising that art needs to be – and is – informed by as much science as we can bring to bear.

For what it is worth, at the time of our last forecast in November, our central projection – on the assumption of 6% interest rates – was for output growth of around 2½% over the next couple of years, with RPIX inflation remaining modestly below target this year but rising to 2½% in 2002. There was, of course, a good deal of uncertainty around that central projection, as there always is, for the reasons that I've tried to explain. But on the basis of that forecast the short answer to the question: can our steady economic progress be maintained, over the next couple of years anyway, is a cautious "yes".

Since that forecast was completed things have gone in different directions. The prospect for external demand has somewhat weakened and so too has the oil price. There are mixed messages relating to tightness in the labour market, but earnings growth has so far remained reasonably well contained - as it must continue to do. On the domestic demand side, private consumption growth has remained stronger than we had supposed, while the growth in private investment has been weaker; meanwhile it is not clear that underlying public sector demand has – at least yet – picked up as rapidly as planned. The exchange rate has fallen, and so, too, have market interest rates.

I would not venture to suggest how these – and all the other developments we look at – will influence our next forecast in February; and it would be pointless to anticipate possible future policy decisions. I would be surprised if they radically altered the broad prospect of relatively steady progress over the next two years. But I can assure you of one thing: if the prospect – or the balance of risks around it – were to change significantly – either in the context of our February forecast or subsequently – we will promptly react to that change. Despite the fact that we left interest rates on hold again last week, we have certainly not gone to sleep!