The Rt Hon Sir Edward George GBE: Macro-economic management in the UK

Speech by The Rt Hon Sir Edward George, Governor of the Bank of England, at the 2001 Institute of Directors Convention, London, on 25 April 2001.

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The theme of your convention is change - and as a general observation what's always struck me about change is that it's not simply a one-off event - a discrete step from A to B. Change is a continuing process - and once you've embarked upon that process it's not always clear where it will lead. You either embrace the process, notwithstanding the uncertainty, it seems to me, or you resist it, with the risk then that the world changes around you and begins to pass you by.

What is certainly true - in this country but much more widely internationally - is that there has gradually over a long period been a very profound change in the approach to overall economic management. For a long period after World War II the emphasis of macro-economic policy seemed to concentrate on aggregate demand management, with too little attention paid to the constraints imposed by the supply-side capacity of the economy to meet that demand. When growth and employment were judged to be insufficient, monetary and overall fiscal policy were used in combination to provide a stimulus to the economy, often supported by direct controls of one kind or another to suppress the emerging symptoms of increasing pressure on resources. Then, as those symptoms -price pressures in goods and labour markets and increasing external deficits - could no longer be contained, the macro-economic policy levers were thrown into reverse. The go-stop policy cycle for much of this period served in fact to aggravate the economic cycle, and our overall economic performance undoubtedly suffered.

We've come a long way since then in recognising that we would do a lot better by aiming at more sustainable growth in the economy, by keeping overall demand more or less continuously broadly in line with our supply-side capacity, thereby moderating rather than aggravating the economic cycle. The emphasis of macro-economic policy has therefore shifted decisively to stability and sustainability, and I will come back to that.

But the shift of emphasis to stability as the objective of macro-economic management has served to focus attention increasingly also on the parallel need to improve the supply-side of our economy - for example by increasing the scope for free trade and increased market competition, both nationally and internationally; by avoiding unnecessary regulation; by increasing the flexibility of goods and labour markets; and by raising the skills of the workforce through education and training. Lord Haskins has just been talking to you about the supply-side of the economy, and it is fundamentally important, because it is our supply-side performance essentially that determines the rate of growth that we can hope to sustain. It is hugely more complex than macro-economic management, being affected as it is by the whole range of public policy issues, often involving difficult political judgements on how to strike the right balance between social and economic considerations. I will have little more to say about the supply side.

My involvement is on the macro-economic side. Macro-economic management can do relatively little directly to contribute to improvement on the supply side, but - if we succeed in maintaining stability - we can nevertheless contribute to more rational economic decision-making by the private sector, based upon real rather than purely nominal considerations; and that can help improve our supply-side performance indirectly.

As the emphasis of macro-economic management - overall fiscal policy and monetary policy taken together - shifted towards stability, a growing distinction emerged between the role of overall fiscal policy, which is set for the medium term, and a more specific role for monetary policy, which became the principal instrument for shorter-term stabilisation. This distinction crystalised first with the adoption of an explicit inflation target as the objective of monetary policy, following our exit from the ERM in 1992, and subsequently, in 1997, when the Bank, through the Monetary Policy Committee, was given independent operational responsibility - legitimised through transparency and public accountability - for the achievement of the Government's inflation target. It is important to understand, however, that the stated aim of consistently low inflation is not simply an end in itself: low inflation is a measure - a barometer if you like - of our success in keeping overall demand in the economy in line with supply-side capacity, so that the underlying aim is economic stability in that much wider sense.

Now it has to be said that this emphasis on low inflation as the objective of monetary policy was not without its critics. Some people argued that "any fool can control inflation simply by holding back growth and employment. It is a recipe" they said "for economic stagnation". Well that has not been our experience since inflation targeting was introduced. In fact we've experienced the longest period of continuous and relatively stable quarter by quarter growth since quarterly records began, with average annual growth at around 3% over the whole period compared with our long term trend rate of 2¼-2½%. Employment has steadily increased, and unemployment has fallen to its lowest level for 25 years. While the rate of inflation has been consistently relatively close either side of the Government's 2½% target - the lowest rate that I suspect most of us can remember. This experience demonstrates - at least to my mind - that there is no necessary trade-off between growth and stability - certainly in the medium and longer term, rather the reverse. And I would hope, on this evidence, that the future evolution of our approach to overall economic management would be in the direction of further improvements to our supply-side flexibility, rather than any retreat from the present emphasis on macro-economic stability.

Of course I am well aware that a stable overall macro-economy does not - and cannot - mean equally stable economic conditions for every individual sector or individual business. A particular complication over the past few years has been the surprisingly persistent strength of the exchange rate against the euro, itself a reflection of the puzzling more general weakness of the European currency. This has contributed to an uncomfortable imbalance within the UK economy primarily between the euro-exposed sectors, which have been under consistent pressure, and the domestically-oriented sectors, which have by and large been doing relatively well. Understandably the suffering sectors and businesses tend to complain that monetary policy takes too little account of their position, often pointing out that inflation has for the past two years fallen somewhat below the target. The implication is that monetary policy has been tighter - interest rates have been higher - than was necessary, which, they say, in turn at least helps to explain the behaviour of the exchange rate.

I hope you won't think me patronising if I tell you that I have genuine sympathy with their concerns. Indeed I very much admire the huge efforts that many of them have made to overcome the disadvantage coming from the strong exchange rate. Imbalance within the economy has in fact been a persistent pre-occupation for us on the MPC.

We necessarily, of course, take account of the exchange rate in trying to predict the future course of the economy. Its strength against the euro has been a factor which has dampened both external demand and the rate of inflation, so that interest rates have certainly been lower than they would have been if the exchange rate had been weaker. It is nevertheless true that, in common with most other analysts, we have not fully anticipated the persistence of euro weakness.

We don't of course have a crystal ball. But even if we had, it is important to recognise that the link between relative interest rates and exchange rates is much more complicated - and indeed more unpredictable - than is often suggested. Our own exchange rate against the euro today, for example, is actually somewhat stronger than it was before our reductions in interest rates this year; and the dollar, too, is substantially stronger against the euro than it was before the much larger cuts in US interest rates. So, in setting interest rates, we can - and do - make allowance in our projections for what has happened, and, on a best guess, for what is likely to happen, to the exchange rate, and that may cause the exchange rate to soften or it may cause domestic demand growth to strengthen, thereby offsetting the exchange rate's dampening effect on the economy. But what we cannot do is to target the exchange rate, without putting the stability of the economy as a whole at risk.

The exchange rate is just one example of the many uncertainties that confront us in our pursuit of the Government's inflation target.

We do not know, for example, with any great confidence what is happening in aggregate on the supply-side of the economy, nor therefore precisely what rate of growth we can expect to sustain. We can observe that there has been less price pressure in both goods and labour markets given the strength of demand in those markets than past relationships would have suggested and we can try to understand the reasons for this change. But while we do in fact make some allowance in our projections for the more benign relationships to continue, we do not actually know very much about the size of the improvement or whether or not it will persist.

There are familiar uncertainties, too, about the prospective strength of domestic private sector demand growth, which remains quite robust for the time being, but which could be adversely affected by confidence effects from developments elsewhere, and which may in any event need to moderate to accommodate the planned acceleration of public spending.

And substantial new uncertainties have emerged more recently, relating in particular to the extent and duration of the slowdown in the United States and to the associated weakness of equity prices, and their potential impact on our economy, as well as to the direct and indirect effects of our own outbreak of foot and mouth disease.

The list could go on. But please don't think I'm complaining. We are paid to look ahead as best we can because of the length of time it takes for monetary policy changes to have their full effect. Our task would be far less challenging if we could predict the future with great confidence. The point I want to emphasise is that monetary policy is in the end an art rather than a precise science, no matter how much science we try to bring to bear on the process. But in looking ahead each member of the MPC has to try to distinguish between what we actually know, what we think is the most likely outcome, and what we fear could happen - we cannot simply act on a hunch. We then have to watch the evolving situation measured against our central expectation for signs that prospective inflationary pressures are proving to be either weaker or stronger than we had, individually, anticipated, adjusting our policy view accordingly.

Given the uncertainties, it should not surprise you that the Committee members disagree more often than not, but usually at the margin, on what should happen in any particular month to interest rates. I regard that as a strength rather than a weakness of the process. It should not surprise you either that even though we consistently aim to hit the target, we rarely achieve it precisely. As a matter of fact, I have been genuinely, and agreeably, surprised that the outcome over the past few years has been as consistently close to the target as it has been. The best we can realistically hope for is that we come close on average and over time. And to achieve that, when we identify developments which are likely to move us away from our target on one side or the other, we must be ready symmetrically to adjust our policy to bring us back on track. That is why, even though the economy as a whole continues to perform relatively well on the data, we have moved interest rates downwards this year, to reflect the emergence of the new downside risks; and it is also why we indicated, in our recent press release, that we will continue to monitor those downside risks. That is not a promise of further interest rate reductions, but it is a promise that we are prepared to move further if we have evidence that those risks are increasing. Given our starting point, with inflation somewhat below target and expected to remain so for a while, we are relatively well placed to weather the storm if it begins to blow more strongly.