

Mervyn King: Stocktake of the UK economy

Speech by Mr Mervyn King, Governor of the Bank of England, at the East Midlands Development Agency/Bank of England Dinner, Leicester, 14 October 2003.

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The Bank of England is back in Leicester. Between 1844 and 1872 there was a branch of the Bank of England in Leicester, located in Gallowtree Gate. Sadly it operated at a loss, in part because the Agent lived in style driving about town in a carriage and pair with two men in livery, and the branch was closed. Only six years ago did we re-establish our links with the City through the creation of a new Agency in the East Midlands. The purpose of that Agency - staffed by four members of the Bank who work in rather less style than their predecessors - is to listen to you and other businesses about what is happening on the ground.

The reports of our Agents around the country are crucial to the Monetary Policy Committee. The information we receive from you, and our other eight thousand business contacts around the country, are key pieces in the large jigsaw puzzle of the UK economy that we assemble each month in order to see the big picture.

Some of the statistical fog hanging over the British economy lifted a week or so ago with the publication of a new picture of demand and output over a number of years. The official statisticians have redrawn the profile of growth in different sectors of the economy. In particular, the data for spending and output in the first half of this year now appear more consistent. But October is often a month in which fog turns into storms. So it is worth asking whether the remaining statistical fog enveloping the UK economy foreshadows stormy economic weather ahead. After a decade of unparalleled stability of both growth and inflation, it is time to take stock.

For much of the 60 years since the end of the Second World War, Britain experienced a succession of economic cycles - variously described as stop-go or boom-bust. On average these were larger than the fluctuations experienced by other major industrial economies. Not only was our growth rate lower, it was also more variable. But the past decade has seen a remarkable shift of fortunes. In the 10 years from the second quarter of 1992, the average annual growth rate of GDP was 2.9%, above the post-war average of 2.5%. Following the adoption of an inflation target in late 1992, inflation averaged 2.5%, the lowest for a generation, and never deviated more than one percentage point from that average. Unemployment fell from almost 10% to around 3% on the claimant count, its lowest level for almost three decades, and has now been virtually unchanged for twenty months, by far its longest period of stability. The terms of trade moved in Britain's favour, raising our national standard of living. And output has risen in every single quarter since the middle of 1992, something that is true of no other G7 economy.

Why were the 1990s so successful? And can that success continue? Four features of our economy lie behind this improved performance. First, the new monetary framework - based on an explicit target for inflation, a high degree of transparency, and, since 1997, independence of the Bank of England - made it clear to everyone that monetary policy was, and would continue to be, targeted on maintaining low and stable inflation. Second, a substantial fiscal consolidation turned a deficit of 8% of GDP in 1993 into a sustainable position for the public finances based on a set of clear rules for government debt. Third, a continuing programme of supply-side reforms, over a period of 20 years, made it possible to reduce unemployment without generating higher inflation. Fourth, although the unexpected twists and turns of the world economy did pose real challenges to monetary policy, especially in the latter half of the decade, those shocks tended to average out over time rather than cumulate in either an upward or downward spiral. In other words, the economic surprises alternated between good one year and bad the next, rather than adding up to "one damn thing after another". In that sense, Lady Luck smiled on us.

Of course, we were not alone in enjoying the 1990s. In the United States growth was so rapid that at least two authors wrote books entitled "The Roaring Nineties" and another chose the title "The Fabulous Decade". In contrast, continental Europe experienced slow growth and heart-searching over structural reforms. As with much else, our economic performance lay somewhere between the excited exuberance of the United States and the relative disappointment of continental Europe. So the UK experienced a *non-inflationary* consistently *expansionary* - or "*nice*" - decade; a decade in which growth was a little above trend, unemployment fell steadily, and, supported by the improved terms of

trade, real take-home pay rose without adding to employers' costs, thus allowing consumption to grow at above trend rates without putting upward pressure on inflation.

Will the next ten years be as nice? That is unlikely. The terms of trade will probably not rise as much in future as they have in recent years - about 10% since 1996 when sterling started to appreciate - not least because sterling's effective exchange rate has fallen by around 7% since the turn of the year. Moreover, there is no longer the margin of spare capacity that has provided a buffer for policy over much of the past decade. So when shocks, as they will, hit our economy it is almost inevitable that there will be somewhat greater volatility of both output and inflation than the remarkable stability to which we have become used in recent years.

But the case for realism about what we should expect is not a case for pessimism; rather the opposite. The macroeconomic framework in this country is sound and proven. And the real benefit from Britain's new-found position of macroeconomic stability is that it provides an opportunity to improve our supply performance - to boost productivity, education and enterprise in order to generate the resources needed to raise living standards. Such improvements are, in the long run, both more important and more glamorous than the rather dull and repetitive role of the Bank of England in trying to maintain macroeconomic stability. The Bank of England is only the referee; you are the players.

Unlike countries such as the United States, which has witnessed a significant and seemingly durable rise in productivity growth, in Britain the underlying rate of increase of output produced for each hour worked has remained broadly stable. We can take some comfort from the latest revisions to the National Accounts which show that productivity growth was not as depressed as previously thought, but it still remains close to its long-run trend of around 2% a year, insufficient to close the productivity gap between ourselves and our major competitors.

Of course the Bank of England has to look to improve the quality and professionalism of its own activities. And, together with the Court of the Bank, the new executive team is exploring ways to enhance the effectiveness of our operations. Improving our market intelligence, refocusing our financial stability role, and making central services more professional, are examples of ways in which the Bank aims, in all its activities, to pursue standards of excellence, as it has in monetary policy. There is one additional area where change could prove beneficial. After the Monetary Policy Committee decides on the level of interest rates, that decision must be implemented in the money markets. The Bank will be carrying out a review of its money market operations with a view to improving and simplifying them, and reducing overnight volatility in those markets. The Bank's Markets Director, Paul Tucker, will be consulting the market shortly.

For the United Kingdom as a whole, pressing on with reforms to raise productivity is essential to future prosperity. The strategy which the MPC has pursued in recent years - stimulating domestic demand to compensate for weak external demand in the face of a strong exchange rate - carries the risk that there could be a sharp correction to the level of consumer spending at some point in the future. That risk is exacerbated by the continued strength of the housing market and associated borrowing that we have seen in recent weeks. It is possible that such weakness of domestic demand might be offset by an improvement in productivity, although as yet few signs of that are observable.

Three lessons from past monetary policy experience are relevant to the present position. First, monetary policy can target only the aggregate price level. And inflation expectations are now firmly anchored on the inflation target. But the risk of a correction to consumer spending derives from the possibility of sharp movements in relative prices, particularly of assets. Expectations of the key relative prices within the economy, such as asset prices and the exchange rate, are volatile and difficult to measure, and changes in them are often desirable signals to producers and consumers alike. So it would be a mistake to target those relative prices. But understanding how they affect the expectations and spending decisions of the players in the economy is an essential part of monetary policy.

Second, it is easier to measure the money value of spending and output in the economy than to split it into estimates of "real" output, on the one hand, and price indices, on the other. That is why the latest data revisions have altered the picture of real growth over recent years, leaving estimated money spending and output broadly unchanged. In such circumstances it is sensible to focus on money spending. Indeed, the success of the new monetary framework can be seen in the stability not just of retail price inflation but also of the growth rate of domestic demand in money terms. Over the past few years the annualised growth rate of nominal domestic demand has remained in the range of 4½% to 5½%, a much greater degree of stability than experienced for many decades.

Third, it is extremely difficult to anticipate the future path of interest rates. That is because the Monetary Policy Committee sets rates in response to news in the economy, and that news is inherently difficult to forecast. Each month the Committee makes a careful assessment of the outlook for inflation, and it is that which will guide our decisions on the appropriate level of interest rates. It is over 3 1/2 years since interest rates were last raised - the longest such period since Bank Rate was held constant at 2% through the 1940s. At some point reducing the present degree of monetary stimulus will be necessary in order to keep inflation on track to meet the target. The timing of any such decision will reflect our judgment of the outlook for inflation. Listening to our business contacts and learning from our visits around the UK is an important input into that judgment.

To retain the unrivalled degree of stability that we achieved during the “nice” decade will be an even more difficult challenge for the future. The present monetary and fiscal frameworks provide a seaworthy policy vessel, but, as all sailors know, fog, especially statistical fog, can be dangerous. So we must hope that Lady Luck will continue to smile on us.