Mervyn King: Monetary policy developments

Speech by Mr Mervyn King, Governor of the Bank of England, at the Eden Project, Cornwall, 12 October 2004.

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A year ago I described the period since the early 1990s as a ***n***on-***i***nflationary ***c***onsistently ***e***xpansionary - or **"*nice*"** - decade; a period in which growth was above trend, unemployment fell steadily, and inflation remained low and stable. The ups and downs of the economy were much smaller in the ***nice*** decade than in any previous historical period. Will this stability last?

To answer that question it is necessary to understand the causes of our new-found stability and, in particular, the link between growth and inflation. In the long run there is no trade-off between the two. Monetary policy determines inflation and the supply capacity of the economy determines the rate of growth. In the short run, however, it is reasonable to suppose that when the economy is running at above-normal levels of capacity utilisation there is upward pressure on inflation, and the opposite to hold when the economy is running below capacity. Such, at least, is the conventional wisdom. But over the ***nice*** decade inflation was much less sensitive to movements in output and employment than in the earlier inflation-prone 1970s and 1980s. Inflation barely moved despite substantial falls in unemployment. Indeed if you were to plot inflation against unemployment on a chart - described by economists as the Phillips' curve - you would see not a downward-sloping line of the conventional wisdom but a completely flat line. Over the ***nice*** decade, the unemployment rate fell from nearly 9% to below 3% on the claimant count measure. Yet over the same period, inflation was broadly constant and never deviated from its target rate by more than 1 percentage point. Not only was there no long-run trade-off between inflation and unemployment, there was no short-run tradeoff either. As a result, both inflation and unemployment were lower than the Monetary Policy Committee had expected. And the inflation figures released this morning, with CPI inflation at only 1.1%, show that inflation has remained low - below the 2% target - despite a tight labour market. The position was very different in the 1980s. Unemployment then fell by a similar amount, from around 11% in 1985 to just over 5% in 1990. But inflation rose from 5 to 9.5%.

How should we interpret this reduced sensitivity of inflation to changes in unemployment? Does it mean that the economy can grow faster than before without leading to a pickup of inflation? Or is there a risk that the apparent insensitivity of inflation to movements in the economy is only temporary, and might lead to mistakes in monetary policy if low inflation were taken for granted? To answer those questions, I want to consider **three** possible explanations for why inflation has not so far risen despite substantial falls in unemployment and spare capacity.

First, reforms enacted over the past twenty-five years have made the labour market more flexible and lowered the rate of unemployment consistent with stable growth in money wages. Incentives to work have increased - through initiatives like the New Deal and the Working Tax Credit. Benefits paid to the unemployed have fallen relative to earnings. And the share of wage settlements covered by collective bargaining has fallen sharply. Those reforms, and a steady growth in total money spending, ensured that unemployment fell in almost every quarter since 1992 while wage inflation remained broadly stable. Moreover, changes in unemployment have resulted in smaller movements in the rate of wage increases than in the past. It is possible that migrant labour may be easing the bottlenecks and skill shortages in what is undoubtedly a tight labour market. Reports from our business contacts around the country, collected by our Agents, suggest that migrant labour is indeed relieving some of those shortages, more so in recent months with recruitment from the new members of the European Union. Migrant workers are employed in fish processing here in the South-West, and even in the production of Cornish pasties, as they are in an increasingly wide range of industries in manufacturing, construction and services. That may be suppressing signs of underlying wage pressure that would otherwise have become evident by now.

Second, an increase in the pace of productivity improvement may have made it possible for output to grow more rapidly without adding to inflationary pressure. On the face of it, however, there is little evidence for this hypothesis. Productivity in the private sector - measured as output per hour worked - has grown at an annual rate of around 2 ½ % since 1995, around the average rate in the period 1980-1995. In the United States, private sector productivity growth increased from 1 ½ % in the earlier period to almost 3% after 1995. It is striking that productivity *growth* in the private sector was higher in

Britain than in the United States for most of the past quarter of a century, although our *level* of productivity remains inferior. Only in the past few years has American productivity accelerated. No such change is yet visible in the official data for the United Kingdom. It is possible that the effect of productivity improvements, especially the temporary boost to profits, was obscured by the impact of the rise in sterling since 1996 and by global competition which have lowered prices and compressed margins. So it is too soon to dismiss the possibility of an acceleration in productivity similar to that experienced in the United States. Indeed, productivity growth has increased to more than 4% over the past year. Revisions to the official data and the volatility of measured productivity - reflecting the business cycle - make it extremely difficult to infer changes to long-term growth rates. The absence of any compelling evidence for a rise in underlying productivity growth suggests that this is an unlikely explanation for consistently low inflation over the past decade.

Third, the new monetary policy framework - a symmetric inflation target and the transfer of interest rate decisions to an independent Bank of England - has helped to anchor inflation expectations to the target. It is less likely now that a shock to inflation would lead to a further and persistent deviation of inflation from target. There is a belief that inflation will soon return to target. As a result, a surprise movement in inflation is expected to be temporary and so less likely to lead employers and employees to adjust their desired prices and wages. And there is convincing evidence that changes to inflation are much less persistent under the new monetary policy arrangements.

So there you have it: three possible explanations for the recent low and stable level of inflation despite falling unemployment and rapid output growth. But this is no time for complacency or hubris. Part of the improved short-run trade-off between growth and inflation may reflect temporary factors. Inflation may have been close to target because of one-off explanations, such as increased competition that temporarily depressed retail prices relative to costs, or larger flows of migrant workers that have temporarily held down wage inflation. And even if inflation expectations are well anchored to the target they will remain so only if interest rates continue to be set to keep inflation close to the target. The 1980s provided a stark example of a rapid acceleration of prices with few early warning signs. From 1983 onwards, RPIX inflation was stable - relative to recent experience at that time - with most of the outturns in the 3.5% to 5.5% range until mid- 1989, and wage inflation was high but not on any clear upward path. Within a year, and despite a 6 percentage point increase in interest rates between 1988 and 1989, RPIX inflation reached 9% and wage inflation exceeded 10%. Inflation expectations, as measured by surveys, began to rise as soon as inflation itself took off.

What does this analysis mean for the future path of interest rates? For some time the Monetary Policy Committee has been expecting a rebalancing of the economy as domestic demand, especially consumer spending, slowed in order to make room for faster growth in public spending, net exports and investment. Revisions to the official statistics suggest that consumer spending has slowed to a more sustainable rate over the past two years from its heady pace during the previous five years. Investment has now picked up, growing by over 7% over the past year. And this has been against the background of the fastest growth of the world economy for almost thirty years. The British economy is facing strong pressure of demand on supply capacity, on the one hand, and low inflation, below the 2% target, on the other. Whether that combination can or will continue is, as I argued earlier, not easy to know.

Since our August *Inflation Report*, the rise in oil prices, now at their highest level in real terms for twenty years, has moderated somewhat the outlook for the world economy. And there have been two developments at home, with conflicting implications for inflation. First, there are some signs that the economy is experiencing a softer patch after rapid growth in the first half of the year, even if the official production data are not entirely easy to square with business surveys. Second, sterling has fallen significantly, by some 4% on its effective rate against all other currencies, from its previous high level, and there is continuing rapid expansion of total money spending, broad money and credit.

Looking ahead the MPC will have to balance the impact on inflation of this evidence of weaker activity against the fall in sterling and other signs of cost pressures. The implications for interest rates will depend on developments in the economy which the MPC will monitor carefully both in the official figures and through our regular visits to this and other parts of the United Kingdom. So, if you are interested in the future path of interest rates, don't read my lips, read the economic data!

What is clear, however, is that the combination of low and stable inflation and continuously falling unemployment must come to an end at some point, and may already have done so. Starting, as we do now, with little if any spare capacity, it is unlikely that we can expect unemployment to fall indefinitely. From time to time shocks will hit our economy, as we have seen with oil prices and world trade, and so there will be fluctuations in growth and unemployment, as well as in inflation. Unemployment can be maintained at lower rates than in the past, even though there will inevitably be times when it will rise because no monetary policy can hope to prevent all fluctuations of demand, output, and hence employment. The ***nice*** decade we might expect to be followed by the ***not-so-bad*** decade.[1]

Moving from a ***nice*** to a ***not-so-bad*** decade would still represent a significant improvement in our economic fortunes compared with the period of high inflation. We must be conscious of the dangers of hubris. After all, starting from the Garden of Eden there can be only a fall from grace.

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[1] For those looking for a suitable acronym let me suggest that the degree of stability to which we can reasonably aspire, in comparison with the ***nice*** decade, will be ***n***ot ***o***f ***t***he ***s***ame ***o***rder ***b***ut ***a***lso ***d***esirable, or ***not-so-bad***.