Mr George outlines monetary and exchange rate policies for sustainable growth

Speech by the Governor of the Bank of England, Mr E A J George, at The Central Bank Policies Conference, Macau, 17 May 1999.

Mr Chairman, Ladies and Gentlemen, let me begin by saying that it is a real pleasure to be here with you today in Macau and to participate with such distinguished central bank colleagues in your conference.

One of the very agreeable things about coming to the other side of the world to participate in an event like this is that it enables me to step back from the daily hubbub of my office, the financial markets in the City of London, and the media, and reflect in a broader way on what it is we are all actually trying to do. It is in fact much more agreeable than working!

In a broad sense, of course, our ultimate objective as central bankers is clear, and it is reflected in your conference title when you talk about "leading the way to sustainable growth". I would add high rates of employment and rising living standards to that objective.

Very often in the past, certainly in my own country, but not just in my own country, that fundamental objective was seen to be largely a matter of demand management – of pumping up demand by expansionary fiscal and monetary policies – with too little regard to the structural, supply-side, capacity of our economies to meet that demand. There is not much that overall fiscal policy, still less monetary policy, can do directly to affect the supply-side capacity of the economy: they operate essentially on the demand side. And our recurrent experience showed that excessive demand growth spilled over into inflation and a worsening balance of payments which ultimately had to be corrected – the infamous boom and bust cycle. This macro-economic instability damaged the supply side of the economy, with a worse outcome over time in terms of our ultimate policy objective. It is now very widely understood that "stability is a necessary condition for sustainable growth" and that, of course, has become the universal central banker's mantra.

But the question is stability of what? You obviously cannot sensibly aim to stabilise everything. The aim has to be sustainable growth of the economy as a whole. But that cannot mean stable growth for every sector of the economy or for every business enterprise. Consumer demands change over time and so, too, do technologies and production techniques. Open market competition to identify such changes, and to exploit them to meet social needs more efficiently, is a vital driver of improvement on the supply side of the economy. At the micro-economic level, that means that particular sectors and individual businesses will continually rise and fall; and that is why established producers everywhere often see new competition, perhaps especially international competition, as an unwelcome threat. But at the macro-economic level what we have to remember is that every dollar earned is a dollar available to be spent or reinvested back into the economy, whoever earns it. So, at the macro-economic level, competition – the driver of economic progress – is a positive sum game; it increases the potentially sustainable growth rate nationally, regionally, and internationally. How far each country individually is able to take advantage of this increased potential depends upon how flexibly it can adapt to changes in comparative productive advantage – which in turn depends upon the supply–side characteristics of our separate economies. But there is no doubt that we all stand to benefit. That is why I have always believed fundamentally in the principle of free trade and open capital markets which enhance competition. It is why I have always welcomed the rapid growth we have seen in the emerging market economies – and why incidentally I look forward to China's accession to the WTO.

We cannot then sensibly aim to obstruct structural changes. But nor can we realistically hope to avoid all shorter-term fluctuations, associated with the business cycle for example or as a result simply of random shocks. What we are looking for is a stable macro-economic framework for the economy as a whole, which will help to moderate rather than aggravate shorter-term fluctuations, and one within which change can occur in response to longer-term real economic factors, undistorted by unnecessary, erratic, movements particularly in nominal values.

In a totally closed, national, economy I suspect that the most effective way of achieving this would be to aim to stabilise the rate of consumer price inflation – at some very low level representing effective price stability. We might, certainly, as an intermediate step aim to stabilise the rate of growth of the money supply, if we were confident that the demand for money was sufficiently stable and predictable, but the reason for targeting the growth of the money supply would ultimately be to stabilise the rate of inflation, so the distinction is operational rather than substantive.

But it is important to understand that effective price stability would not be intended simply as an end in itself. In order to maintain price stability, what in fact we would need to do is to keep overall demand in the economy continuously broadly in line with supply-side capacity, so that the actual rate of inflation is really a measure, or barometer if you like, of our success in maintaining macro-economic stability in a much wider sense. If we succeed in maintaining such stability, that would also contribute, indirectly, to improving the supply side of the economy by reducing nominal uncertainty as a factor in spending or saving or investment decisions and thereby improving resource allocation.

Macro-economic stability in this sense can of course be affected by either overall fiscal policy or by monetary policy. But frequent fiscal policy changes - to tax rates or expenditure programs – can generate micro-economic uncertainties so that short-run macro-economic stabilisation is normally left primarily to monetary policy. It is important nevertheless that the two arms of policy pull in the same general direction to avoid unwanted sectoral or related regional distortions.

In a totally closed economy therefore the objective of macro-economic stabilisation and the respective roles of fiscal and monetary policy would be reasonably clear.

But none of us – very fortunately in any wider context – actually lives in a closed economy. We are all vulnerable to external shocks to varying degrees, including of course, increasingly, shocks resulting from international capital flows. Free trade and open capital markets do, as I noted earlier, bring huge benefits in terms of supply-side improvements from which we all, potentially, stand to gain. But there is no doubt that economic globalisation can at times massively complicate our national efforts at macro-economic stabilisation and it is this problem which I should like to address in the rest of my remarks.

A key issue is how far we can protect our internal macro-economic stability through our choice of exchange rate regime. My short answer to that question – from the UK's experience – is that there is, sadly, no ideal solution!

The effective options range from floating, through some form of adjustable peg, to a quasi-fixed exchange rate by way of a currency board or, ultimately, full monetary union. Each option has its pros and cons.

Let me start with floating. At first blush the idea of allowing the exchange rate to take the strain, as a kind of buffer, insulating the domestic economy from shocks emanating abroad appears very attractive. Unfortunately it does not necessarily work like that. A floating exchange rate may move erratically in response to market news, causing unwarranted movements in the real exchange rate. That, of course, may be an important influence on domestic costs and prices; it may affect the relative competitiveness of domestically and foreign-produced goods and services leading to changes in the net external trade position, affecting aggregate demand in the domestic economy. So the insulation provided by a floating exchange rate may prove to be more apparent than real.

The UK has been floating since 1992. For some years we experienced very little tension between our domestic and external policy needs. But then, from the autumn of 1996 we saw a sudden appreciation of some 20-25% in our Effective Exchange Rate against the core European currencies, and seemingly, largely related to uncertainties about the future characteristics of the European single currency. Whatever the reason the strengthening of the exchange rate had a dampening effect on the domestic price level, and a subsequent deterioration of our trade balance (accentuated over the past year or so by the global economic slowdown) reduced aggregate demand in the economy. Monetary policy accordingly needed to be less restrictive than would otherwise have been appropriate to offset these effects on domestic demand. The aim was not to achieve a particular level of the exchange rate but to compensate for its deflationary impact. When the exchange rate weakens – as we anticipate that it will in due course – then monetary policy will at some point need to offset that influence in the opposite direction. But in the meantime we have had to manage as best we can a severe imbalance between different sectors of the economy, with the internationally exposed sectors taking a considerable hammering. Despite reasonable macro-economic stability in the economy as a whole, the environment has been anything but stable for those sectors.

For a period before 1992 we sought to manage the exchange rate, initially by informally shadowing the DM and subsequently by pegging sterling within the framework of the European Exchange Rate Mechanism. Both these episodes ended in tears, essentially for the same reasons: attempting to manage the exchange rate required us to pursue macro-economic policies which were inconsistent with our own domestic macro-economic needs. In the first case shadowing the DM involved accentuating a domestic boom; in the second case our membership of the ERM, at a time when reunification required abnormally tight monetary policy in Germany, involved us in pursuing an unnecessarily restrictive monetary policy deepening and prolonging recession. In that case, too, the formal commitment made exit more difficult, the exchange rate fell very sharply, and we made a very substantial financial loss as a result of massive foreign exchange intervention seeking to defend the ultimately indefensible. While they lasted these regimes provided a degree of nominal exchange rate stability which no doubt helped the internationally exposed sectors of the economy. But the price ultimately was substantially increased instability in the economy as a whole.

Of course, some commentators have argued that the problem we had within the ERM was the exchange rate at which we entered rather than the form of the arrangements. I am not convinced. The divergence between our domestic policy needs and those in Germany was such that it seems unlikely to me that any plausible difference in the exchange rate initially chosen for the peg would have made very much difference. But in any event the range of uncertainty surrounding the choice of a sustainable peg is an important part of the problem with any pegged or fixed rate regime.

The UK has not recently experienced a fully fixed exchange rate regime – although we remain a potential member of European Monetary Union. But the basic economic pros and cons of a fixed rate regime are somewhat similar. Essentially the very real advantages are nominal exchange rate certainty within the Euro-zone – which accounts for some 50% of our external trade as well as participation of the domestic economy in broader, more liquid, pan-European financial markets. (The City of London is, of course, already a full participant in the European financial markets – indeed it is the major contribution that we can make at this stage in the development of the new currency.) These are very considerable potential economic benefits which will lead to more efficient resource allocation across the euro area. The potential downside is the risk that at times the single European monetary policy will not meet the domestic monetary policy needs in all the individual participating countries – in other words that there will be problems of sectoral and regional divergence which are very familiar in larger economies at the national level, but on a larger, regional European, scale. The jury is still out on this question.

Based on our experience it seems clear, as I say, that there is no clear best solution, applicable at all times for all currencies, to reconciling the inherent problem of potential conflict between the needs of domestic and external stability.

The choice depends very much upon the country's particular circumstances.

Floating may be more attractive to a country which has a small tradeable sector relative to the size of its domestic economy, but in that case it will need an effective nominal domestic anchor, such as a money supply or inflation target; and it will need an institutional structure – typically an independent central bank – to reinforce the credibility of the commitment to that nominal anchor.

At the other extreme a fixed rate regime may be more attractive to smaller, more open, economies or where a credible domestic macro-economic framework is difficult to establish, for example, for historical or political reasons. But in this case it is crucial to recognise that domestic policy must be totally and unreservedly committed to maintaining the fixed exchange rate. It is an extremely demanding regime but one which can work well – as we have seen in Hong Kong – where there is a high degree of supply-side flexibility to act as an alternative external shock absorber.

It has become increasingly fashionable recently to exclude anything between these two extreme positions – an actively managed float or a pegged rate regime – as an unviable middle ground. It is argued essentially that because they do not exert a sufficient discipline on policy in either direction, or therefore represent a sufficiently clear policy framework, they tend to intensify market tensions when a divergence between the policy needs of domestic and external stability does in fact arise.

I am reluctant to accept that so-called “corner” view in any absolute sense. When tension does arise between external and domestic objectives, you cannot avoid the impact on domestic policy altogether even with a floating exchange rate regime – as I explained in the context of our own recent experience. It may help to reduce that tension to attempt to manage the float to some degree, by supporting appropriate domestic policy action with exchange market intervention, though I agree that such intervention may serve as little more than a signal where a currency is internationally widely traded and held. Similarly there can, I believe, be circumstances in which domestic discipline may be reinforced by an exchange rate peg, but it is vital in that case that the authorities should identify a clear exit strategy before serious tensions are allowed to emerge. That – I know from our own experience – is much easier said than done!

Mr Chairman, these dilemmas are certainly not new. But clearly they are liable to be accentuated by the massive increase in global capital flows over recent years, which has not only complicated the choice between alternative possible exchange rate regimes but also made the management of any of those regimes substantially more difficult.

So there is a further question we need to address which is whether there is anything we can do to reduce the volatility of these massive capital flows beyond pursuing disciplined macro-economic policies. That of course is the subject of a whole series of conferences on its own; and there is certainly a good deal that we can do. Let me conclude by mentioning some of the items on my own shopping list in this context.

First, at the recipient end, a crucial condition for living with financial globalisation is improvement of market structures to ensure that capital inflows are productively employed. That involves attention to structural issues, such as accountancy standards, bankruptcy laws, and governance questions. It involves appropriate sequencing of capital account liberalisation – and arrangements to ensure that the particular risks to the borrowing country, for example, attaching to volatile short-term inflows are properly recognised – and reflected in the price paid by the borrower. That in turn involves effective management of foreign currency assets and liabilities in particular, including management of their relative liquidity, by both the public and private sectors. It involves, also, ensuring that borrowers, and their creditors, are unambiguously clear as to who is ultimately responsible for the liability at the time it is taken on. It involves increased attention more generally to the soundness of financial systems – which is to be the subject of our discussion this afternoon. And perhaps above all it involves improved transparency – of policies, of standards, and of financial and economic data - to enable investors and lenders to make informed assessments of risks.

But there is a great deal too that the international financial community can do, as it were from the provider end. This includes the intensive efforts being made, particularly by the IMF, to encourage sound macro-economic and structural policies – and greater transparency – in all IMF member countries. It includes intensified efforts by financial regulators particularly – at the national level but also working collectively through the new Financial Stability Forum, the Basle Committee and IOSCO for example – to improve prudential standards of financial behaviour. And it includes the provision of official financial support to countries that are pursuing sound policies – in parallel with continuing private finance, on which the risks would have been reduced both through the parallel official finance itself and through official international endorsement of the borrowing country’ s policies. In this context I think we in the official sector may have placed too much emphasis in international discussions on "bailing in" the private sector – which can sound ominous, even threatening – where what we really need is recognition of our mutual interest in public-private sector partnership.

It is a heavy and complex agenda which is being very actively pursued in many different international groupings, involving both the industrial and emerging countries, across a broad front. We are I believe steadily moving towards consensus or many of the issues and this is "leading the way towards sustainable economic growth" into the next millennium. In the meantime we are collectively having to manage the consequences of the recent global financial disturbances and their economic after-effects. Happily we have recently been making progress on that too, particularly in many of the emerging countries here in Asia.