BANK OF ENGLAND

Speech

Speech by the Governor at the Institute of Directors Annual Dinner

Speech given by

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At the Royal Lancaster Hotel, Hyde Park

19 November 1998

My Lord and President, Deputy Lord Mayor, Your Excellency, My Lords, Ladies and Gentlemen.

Let me put some of the recent newspaper headlines alongside the facts, in order to put things in perspective.

First, on the world economy, the headlines read:

- Meltdown warning in the wake of economic slowdown.
- G7 nations try to halt slide to depression.
- Last ditch bid to avert global crisis.

And these are just the supposedly serious newspapers!

The facts are that world output growth is expected by the IMF to be 2% this year and 2½% next - compared with 4% in 1997. And the OECD expects growth in the OECD area of 2¼% this year, 1¾% in 1999, recovering to 2¼% in the year 2000 - compared with 3% in 1997. That certainly is a very marked slowdown, but it is hardly meltdown or recession.

And on our own economy - the headlines read:

- Recession looms.
- The economy is hurtling headlong towards recession.

And even:

- It's official - the economy is shrinking.

The facts are that for the past 6½ years the British economy as a whole has grown at an average annual rate of over 3% - which is well above its long term trend rate of some 2% - or, if you are optimistic, some 2½%. And we were still growing, at an annual rate of some 2% in each of the last two quarters, on the latest published data.

At the time these headlines were written a month or so ago not one of the 28 independent professional forecasting organisations surveyed by Consensus Forecasts was expecting output to fall in 1999; and their average expectation was for 1% growth next year. That is broadly in line with our own latest best guess in the MPC. Your own most recent IOD forecast in September suggested slightly stronger growth next year. It is true that Consensus Forecasts have since revised down their mean expectation - to just over ¾% growth; but even now only one of the 28 contributors expects output to fall.

On unemployment in the UK the headlines read:

- Jobs gloom deepens as layoffs soar.
- More jobs go as recession looms.
- Jobless up as world pain hits Britain.

And the facts? At the time these headlines were written, the unemployment rate, both nationally and in virtually every region of the UK, apart from the South East and East Anglia, was the lowest it has been since at least the early 1980s.

I could go on.

Headlines: UK heads for credit crisis. Closed for credit. Credit card sales dive. Facts: bank and building society lending up by 0.7% in the latest month (September) and by 8.8% over the past year. Credit card lending was up by over 26% on a year ago.

Headlines: House prices hit as recession clouds gather. Facts: house prices rose by 6.7% over the past year on the Halifax index and by 7.5% according to the Nationwide.

Now I say all this, President, not to draw attention to the proclivity of headline writers, and some economic/financial commentators, to sensationalise. My serious point is that, especially at a time of unusual uncertainty as at present, we all need to focus more carefully than ever on the evolving facts, and on the more probable outcomes and not allow ourselves to become preoccupied with extreme, even if possible, outcomes.

Against that background, let me offer you my own assessment of where the UK economy has come from and where it is headed.

Since the recession of the early 1990s the economy as a whole has, as I say, grown at an average annual rate of just over 3% - well above trend. During this period we were steadily reabsorbing the spare capacity created by the recession, and this was reflected in a gradual improvement in the labour market - in a net increase in employment of 1.7 mn people since the end of 1992, and in a persistent fall in unemployment to - as I say - the lowest rate for nearly 20 years. Meanwhile, underlying consumer price inflation has averaged 2.7% over the past 5 years, the lowest rate since the early 1960s - and it has been exactly on target - at 2½% - in each of the past 3 months.

About 2 years ago it began to become evident that demand and output growth, in the economy as a whole, was picking up speed. And as we moved into and through 1997, it became increasingly obvious that unless

we acted to tighten monetary policy, in order to moderate the rate of growth, we risked overheating, particularly in the labour market, where reports of shortages not just of skilled but even of unskilled workers, were becoming widespread.

The situation was seriously complicated by an increasing imbalance between the domestic and the internationally exposed sectors of the economy. Domestic demand for goods, and particularly for services, was unsustainably strong, and large parts of the economy were doing very well on the back of that - though they didn't make too much of a song and dance about it. But other sectors, those most exposed to international competition - most of agriculture, large parts of manufacturing and some service sectors - were already then having a much more difficult time. Understandably, they were more vociferous. They had been hit, initially, by the exaggerated strength of sterling against the major European currencies in the run up to decisions about the euro. And they were hit, subsequently, by the successive waves of turmoil spreading through the world economy which saw exchange rates fall and demand dry up in Asia and elsewhere.

So, faced with this dilemma, what were we to do? It is true that the external factors - unhelpful as they were in a more fundamental sense, in terms of the imbalance in the economy - did act as a restraining influence on overall aggregate demand and on inflation, and that meant we had somewhat more time than we would otherwise have had to moderate the growth of domestic demand. But even allowing for that we in fact had no choice but to tighten policy.

It wasn't that we didn't know that the internationally-exposed sectors were under the hammer - we'd have had to be blind as well as deaf not to have known. Our problem was that if we had held back more than we did, in order to shelter the exposed sectors, we would have put the whole economy - including the sectors we were trying to protect - at risk of accelerating inflation. And that would have meant eventually having to tighten policy more abruptly, which would much more certainly have plunged the economy into serious recession, a bit further down the road.

The harsh reality is that monetary policy can only target the economy as a whole - it cannot realistically seek to shelter particular businesses or particular sectors or particular regions, however much we might all wish it were otherwise. And, in relation to the economy as a whole, the effective choice in the situation we faced was not whether or not to tighten, but whether to tighten sooner, and by less, or later, by more.

So we raised interest rates through the second half of last year - and again in June - trying, as best we could through our tactics, to minimise any further unwanted upward pressure on sterling.

But things have now clearly moved on.

The outlook for the world economy deteriorated further through the summer under the impact of a series of new shocks. Japan, the world's second largest economy, slipped further into recession. Russia - which had

only weeks earlier embarked on an IMF program - saw the collapse of the rouble and default on its debt. And acute nervousness spread through many of the world's financial markets. Although there has been some improvement in sentiment over the past month or two, and although the US and European economies continue to expand, the likelihood remains that world economic growth will be significantly slower than had been expected earlier in the summer. Slower growth of world activity is bound to prolong the restraining external effect on growth and inflation in the UK, even though the exchange rate has now started to weaken.

At the same time there are also now clearer signs of overall slowdown in our own economy. The evidence for this is less obvious in the backwards-looking economic and monetary data than it is in the forward-looking surveys, but even so the data suggest that we are beginning to see an easing of pressure, including an easing of pressure in the labour market. And the surveys themselves now point to a slowdown in service sector growth, including retail distribution, as well as a sharper decline in manufacturing output.

This prospect is consistent with the reports which we receive directly from the Bank's network of regional agents and their 7000-odd industrial and commercial contacts around the country.

Of course we pay very careful attention to this forward-looking evidence of developments in the economy alongside the data, and, like others, we have revised down our forecasts for output growth and inflation. And we have eased monetary policy quite sharply in the past two months, in the light of that evidence.

Our current best guess - published in last week's Inflation Report is that, after the interest rate cuts, the growth of overall output next year will be around 1%, picking up through the Millennium to around trend in the second half of the year 2000. Meanwhile, we expect underlying inflation to remain close to the target rate of 2½% - though perhaps a little above that rate during the course of next year. Now no-one likes to see the economy slowing down, but some slowdown was necessary at this point in the economic cycle in order to avoid an inflationary upsurge. And if in fact it proves to be as mild as most of the forecasts - including our own - suggest, it will be a huge improvement on anything we have seen at this stage in the cycle for decades.

It is true of course that the economy may turn out to be weaker than in our central projection. That projection is the MPC's very carefully considered view as to the most probable outcome, but there is considerable uncertainty around it; and the risks are somewhat more on the down than on the upside. We don't have a crystal ball. And we don't pretend to know at all precisely just how things will in fact turn out - that's why we publish our forecasts in the form of a fan with a wide range of uncertainty around the central case. The people to watch out for in this field are those who do claim to know precisely. What we have to do, in actually operating monetary policy is to monitor all the relevant evidence as it emerges for signs that the economy is proving to be either stronger or weaker than we expect, and modify our view of the prospect for inflation - and our monetary policy - in the light of that. And in that context I repeat the assurance, which I gave recently to the TUC in Blackpool, that we will act symmetrically. We will be - have been - just as rigorous in reducing

interest rates with the overall evidence pointing to the balance of risks to inflation on the downside, as we have been - and will again be - in raising rates with the evidence pointing to a significant or sustained overshoot of the inflation target.

Now there are those - perhaps even one or two of you here this evening - who regard this assurance as cold comfort. It misses the point - they say - because the present approach to monetary policy focuses too narrowly on inflation. What we want - they say - is a monetary policy which puts more emphasis on growth and employment. You hear this complaint not just in this country but increasingly these days in Continental Europe. I must say, President, that it leaves me totally bemused.

What it suggests is that growth and price stability are seen as alternatives - you can have a bit more of one if you're prepared to accept a bit less of the other. I must confess that I thought the debate had advanced beyond that point and that we really had learned from bitter experience that there is no trade-off of this sort. In anything other than the short term you can't have one without the other.

We've tried all too often in the past to increase the growth rate of the economy simply by pumping up demand - without sufficient regard to the underlying, supply-side, capacity of the economy to meet that demand. The result, repeatedly was inflationary boom followed by inevitable bust, and this repeated experience itself engendered a pervasive and damaging short-termism, in both industrial and financial business behaviour. That simply made the position worse next time around. What we - and the Bundesbank, and the ECB in future - have to try to do is to keep overall demand growing broadly in balance with the underlying supply-side capacity of the economy, aiming to dampen rather than aggravate the economic cycle; and consistent price stability - certainly not falling prices but not accelerating price increases either - is the measure of our success in achieving that broader objective over time. The debate is not about the ends, it is about the means. Price stability has never to my mind been simply an end in itself - it would be a pretty dry and unsatisfying objective if that were all that we were about. The whole point about price stability - even when, as now, it involves a temporary slowdown in the growth of activity - is that it is a necessary condition for the sustainable growth of activity and employment and rising living standards, which are of course the truly good things of life, and which we surely all want to see. That is, I think, what we have seen over recent years.