



BANK OF ENGLAND

# Speech

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## **National Council of Building Material Producers**

Speech given by

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Few industries have suffered more from volatility of the British economy than yours, and the past few months have been more volatile than most. "The times they are a-changing" would be an appropriate theme tune for all of us. What has changed the economic climate over the past two to three months? Here at home the most obvious sign has been a sudden decline in business and consumer confidence. The fall in the CBI's measure of business optimism over the last two quarters is the largest seen since the early 1980s. The level of consumer confidence appears more robust, but it too has also fallen since the middle of this year.

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Away from home, the major development has been increased fragility in the international economy. Following the default on its debt by the Russian government, the imposition of capital controls by Malaysia, and the near collapse of the hedge fund Long Term Capital Management, financial markets world-wide have exhibited extraordinary volatility, driven by a fear of risk, a flight to quality and liquidity, and the beginning of a significant reduction in leverage by financial institutions. What does this turbulence mean for the British economy?

Before answering that question, I want to say a few words about the Monetary Policy Committee. Just under two weeks ago, the Monetary Policy Committee, for the first time in its short history, cut interest rates. When I accepted your invitation to speak today, I did not know that I would be able to explain to you the reasons behind our latest decision. For, until today, the minutes of our meetings were published with a lag of some five to six weeks. But, as the Bank announced earlier this month, the minutes will now be published only two weeks after the monthly meetings. And the minutes from our meeting on 7-8 October were published at 9.30am this morning. This increase in transparency should help commentators and financial markets alike to assess the actions of the MPC and to predict its future decisions. As I have said on other occasions, the aim of the MPC is to pursue economic stability, not to spring surprises on an unsuspecting world. Surprises may be good for newspapers, but not for most other businesses.

So what were the issues facing the MPC two weeks ago? Remember that the aim of the MPC is to hit an inflation target of 2.2. Sometimes inflation will be above the target, sometimes below. But over a run of years the outturn should be as close to 2.2 as possible. It is central to our remit that deviations of inflation from the target are regarded symmetrically. Inflation can be too low as well as too high. For over thirty years, central banks have not, until recently, had many opportunities to show that they understand this. I can assure you that the MPC does. When circumstances change, as they have over the past few months, then so will our policy.

The recent turbulence in international financial markets brings a new set of problems and risks, over and above those that resulted from the Asian crisis which started in the second half of last year. It is important to distinguish between the crisis of the so-called "tiger" economies in Asia, which, although clearly impacting on world trade, was indeed largely restricted to Asia, and the more recent financial contagion which has afflicted almost all emerging markets and affected the financial system of the industrialised world.

There are three aspects of the world economy which are relevant to our own position. First, private capital flows to emerging markets have in many cases come to an abrupt halt. That will have consequences for trade balances and activity in both emerging markets and industrialised countries. Second, falls in equity prices around the world have reduced household wealth. And, third, the sudden increase in risk aversion in financial markets is changing the balance sheets of financial institutions and some fear that this may lead to a credit crunch.

The reduction in capital flows to emerging markets started over a year ago when concerns about the foreign currency exposures of a number of countries led to withdrawals of funds and a liquidity crisis in Asia. That liquidity problem was compounded by macroeconomic and structural problems which varied from country to country. But the net effect was that capital flows to emerging markets in Asia fell from over \$110 bn in 1996 to only about \$10 bn in 1997. That retrenchment has continued during 1998. Why does this matter? In the absence of other sources of finance, a reduction in net capital inflows has to be matched by a corresponding improvement in the current accounts of the emerging market economies. To achieve such a rapid turn-round in the current account required significant depreciations of their currencies and deep recessions. The counterpart to the improvement in the current account of the countries affected is a larger trade deficit, or smaller trade surplus, in the rest of the world. The UK is not immune to this change in trade balances, and the impact of the Asian crisis on our exports has, of course, been compounded by the rise in sterling since 1996.

If the Asian crisis affected most a relatively young, and only temporarily wounded, tiger, the recent turbulence was heralded by the growl of a much older, more grizzly, bear. The announcement by the Russian government on 17 August of its intention to restructure payments on its domestic bonds led to a fundamental reappraisal of international investors' willingness to bear risk. The reappraisal caused the average cost of capital to emerging market economies - measured by interest rates on their bonds - to rise to levels not seen since the immediate aftermath of the Mexican crisis in 1995. This increase in cost is likely to lead to a further reduction in net capital flows to emerging markets and so magnify the adverse trade effect faced by the industrialised world.

Second, the greater aversion to risk has led to falls in equity prices throughout the industrialised world. The FT/S&P world stock market price index has fallen by nearly 12% since its peak three months ago. In the UK, the FT-All Share fell by nearly 20% over the same period. The fall in equity prices is likely to lead to both

lower consumption growth, as consumers adjust to the fall in net wealth, and lower investment growth, as firms react to the higher cost of capital.

Third, the heightened aversion of financial institutions to risk has led to fears of a "credit crunch". A credit crunch occurs when lending institutions try to reduce their exposure to risk and, in so doing, the size of their balance sheets. In recent weeks, the desire of these institutions to reduce the scale of their leveraging and move to less risky portfolios has led to a reduction in the amount of capital available to support liquid financial markets. As a result, asset prices of all kinds have been volatile. So far the consequences of turbulence in financial markets have been largely restricted to securities markets, especially in the United States. These markets are somewhat less important in the provision of corporate finance in the UK, although if the reduction in security market issuance were to persist this could affect the ability of the personal and corporate sectors to obtain finance from both banks and the capital market. As yet lending by UK banks has not been affected to any significant extent. The monetary statistics published yesterday show that total bank credit grew by 0.7% in September, leaving the 12-month growth unchanged at 8.7%.

The MPC will watch carefully for any signs of a credit crunch developing. The Bank monitors indicators of credit conditions in the financial markets on a daily basis. And the MPC has asked the Bank's regional Agents to conduct a survey of borrowing conditions faced by businesses around the country in time for the MPC meeting in November.

The international situation is, of course, only one of the factors that influence interest rates. In the August Inflation Report, the MPC made clear that it expected - indeed wanted - the growth of domestic demand to continue to slow throughout this year and into next. A slowdown is necessary because, as the restraining effects on retail prices from the rise in sterling start to wear off, domestically generated inflation must fall if the inflation target is to be met.

The latest data from the Office for National Statistics show that domestic demand and output have been growing broadly in line with the desired path. But survey data show a markedly weaker picture for output and orders, both over recent months and, more importantly, looking ahead. The lags with which changes in monetary policy affect the economy means that the MPC can not wait to find out whether the surveys provide an accurate prediction before it sets policy. Each month the MPC balances the information contained in official statistics, surveys, anecdote, and the impressions of conditions in industry relayed to us by our network of regional agents.

An issue of considerable importance is the state of the labour market. The August Inflation Report argued that the outlook for inflation depended critically upon the labour market and, in particular, on the behaviour of earnings. At the time of that Report the latest figure for earnings growth was 5.4%. Given historical levels of productivity growth of around 2%, this level of earnings growth was, on the face of it, incompatible in the long-run with the inflation target of 2%. That led to an extended discussion during the summer, both within the

MPC and among commentators in the press and the City, about the extent to which those levels of earnings growth had been distorted by the impact of bonuses during the Spring of this year and so might be expected to fall in due course without the need for an easing of pressures in the labour market.

Since August, the estimates of this key economic statistic have been revised - not once, but twice. The good news - somewhat ironic given the amount of attention it attracted earlier this year - is that as a result of these revisions the "great bonus debate" of the summer has become a non-issue. Bonuses, we are now told, if anything, subtracted from, not added to, the growth of earnings in March and April of this year. The bad news, however, is that if before the revisions it was difficult to know how to interpret the impact of bonuses on earnings growth, it is, I think it is fair to say, now extremely difficult to know how to interpret any aspect of the earnings data.

Statistics, official or otherwise, are neither right nor wrong. They are estimates which are often revised as new information becomes available. But what is striking about the recent revisions is that the changes do not result from any new information about earnings, but simply from a change in the procedures used to weight together the earnings in different firms and industries. It may be that this change has made it more difficult to make comparisons of earnings over time, and hence to measure underlying earnings growth.

Whatever the explanation, there has certainly been a change in the estimated profile of earnings growth over the past two years. The revised data suggest that instead of rising steadily throughout last year, as the economy grew at above trend rates and the labour market tightened, the rate of growth of earnings actually fell. From a peak of 5.3% in February last year, earnings growth is now estimated to have slowed consistently until March of this year, when it reached a level of 3.9%. This deceleration in earnings growth coincided with a period in which, according to the Labour Force Survey, the labour market tightened considerably: employment rose by 360 thousand, unemployment fell by 320 thousand and the unemployment rate fell from 7.8% to 6.5%. Over the same period wage settlements accelerated. And the revised data imply that since March of this year, as the pace of economic growth has slowed, earnings growth has accelerated, from 3.9% in March to 5.2% in June.

It is not easy, therefore, to reconcile the revised earnings data with other information on the labour market. And these data really matter for the MPC's assessment of the UK economy. I can promise you that the Bank, the Treasury, and the Office for National Statistics, will, as a matter of urgency, be working together to try to understand what is happening to earnings.

Decisions on interest rates must take into account not only those factors which I have highlighted this morning - the international economy, the possibility of a credit crunch and uncertainty about the trend in earnings growth - but also a wide range of other information relevant to the outlook for inflation, including the behaviour of the monetary aggregates, which are still growing quite rapidly, and the fall in sterling's effective exchange rate. Over the next two weeks more important data will become available, including the first

estimate of GDP growth in the third quarter, a CBI Industrial Trends Survey, and the monthly report from our regional Agents. At our next meeting on 4 and 5 November, the MPC will take into account all of this information, and occasions like today are part of the process by which we obtain more information and exchange views with those most directly affected by our decisions.