BANK OF ENGLAND

Speech

The Chemical Industries Association: Business Outlook Conference dinner speech

Speech given by

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14 January 1998

I am particularly pleased to be associated with your conference theme of sustainability. The central banker's mantra, with which we start our daily prayer meetings, is:

"Price stability is a necessary condition for sustainable growth"

And sustainable growth we see as effectively synonymous with the long-term macro-economic prosperity which is what we are, of course, all seeking to achieve.

Now I suspect the same is true at the micro-economic level - the level of the individual firm.

There are certainly differences between your perspective and ours. You, in the chemical industry, for example, know what you are doing! I mean you know precisely what you are doing at least in your production processes - where our business is much less precise - a behavioural rather than an exact science, if it is a science at all.

And you are properly concerned with - indeed responsible to shareholders for - the long-term prosperity of your individual businesses. Whereas we - much as we would wish to see you all succeed individually - are concerned with stability and sustainable growth, leading to long-term prosperity, in the economy as a whole.

Even so, I'd find it surprising if, at the micro-economic level, you, too, did not also see sustainability and long-term profitability as necessarily complementary objectives rather than conflicting objectives. In any event, I take macro-economic sustainability as the theme for my remarks this evening.

Many people think that - because the objective of monetary policy is typically nowadays defined by Governments in terms of permanently low inflation - that is seen as an end in itself.

But in fact, as I say, we see low inflation - effective price stability - not just as an end in itself but rather as a means to the end of sustainable growth and macro-economic prosperity.

Rising prices - across the board - are essentially a reflection of imbalance between aggregate demand in the economy and its supply- side capacity to meet that demand.

There is not much frankly that we can do - directly - to affect the supply-side capacity of the economy. That is a function of its structural characteristics, including the productive abilities of both sides of industry, which can be influenced over time by the whole raft of Government policies.

Monetary policy operates essentially on the demand side - aiming to keep the growth in aggregate demand more or less continuously in line with the underlying, sustainable growth in the supply-side capacity of the economy.

I probably need not remind an industrial audience what happens if we get it wrong and let demand run ahead of supply. The inevitable result is accelerating inflation, with all the damage that can cause - by distorting the outcome of investment decisions and obscuring the relative price signals that direct resource allocation.

In the end we know that demand has to be brought back under control. The choice typically is not whether or not to tighten policy but whether to tighten sooner or later; and there is a strong presumption that by tightening sooner - before excess demand really takes hold - we will need to tighten less - to moderate the pace of growth of demand rather than bring it to a shuddering halt or even send it in reverse.

Too often in the past the mistake has been to tighten policy too little and too late, contributing to an exaggerated, boom and bust, economic cycle and thereby encouraging an unduly short-term approach to both financial and physical investment.

So in trying to maintain effective price stability, in trying consistently to achieve the Government's inflation target, of 2½% for underlying retail price inflation, what we are really trying to do is to achieve economic stability in the much wider sense of ensuring that aggregate demand grows in line with our productive potential. If we are successful in that, then the financial and business communities will become more confident of making longer term decisions, and in that way we can contribute indirectly to improving the underlying supply-side of the economy.

This objective is now very widely understood and accepted. But it is, of course, much more easily said than done.

Since the recession of the early 1990s we have in fact been reasonably successful in maintaining this broader economic stability in this country. Inflation has been brought down to, and maintained at, the lowest rate we have seen in a generation; but, even more important, we have also seen relatively steady growth over this period and a sustained and very welcome fall in unemployment.

But it has to be recognised that the going is now becoming more difficult, for two main reasons.

The first is that we began the present period of expansion in 1992 with a good deal of slack, or spare capacity, in the economy - following the recession - and that slack has now been more or less reabsorbed.

In the past year, in particular, the pace of expansion has picked up, to close to 4%, under the impact particularly of strong domestic demand, and that is well above any realistic estimate of the sustainable rate - the underlying rate of growth of supply-side capacity. And this is showing up in the labour market in evidence of skills shortages and in some signs of higher pay settlements and earnings.

If we are not now to run into a period of excess demand and accelerating inflation, the rate of growth of the overall economy needs to moderate - quite soon and quite sharply.

And it almost certainly will moderate during the course of this year, and may indeed have begun to do so. The growth of domestic demand is likely to be held back by the relatively tight fiscal policy as well as by the monetary policy tightening since May; and the effect this year of "windfalls" as a result of building societies' demutualisations will be very much smaller.

And we expect a deterioration in our net external trade position as a result of the strength of sterling's exchange rate and now, too, as a result of the recent developments in Asia.

The difficult questions for policy relate to the timing and the extent of the slowdown that is necessary on the one hand and likely on the other. These are difficult judgements at any time. They are particularly difficult when the economy is already close to full capacity. It is not surprising that commentators differ in degree in their assessments. Economics is not - as I say - a precise science. Neither we at the Bank nor anyone else know with any great precision exactly where we are in relation to full capacity or exactly how fast capacity is growing; and we don't know precisely either how demand will in fact respond to the policy tightening that is already in place. Our own best - and very carefully informed - guess is embodied in the forecasts that we publish each quarter, and we monitor immensely carefully the new information that becomes available day by day in the light of that forecast for early warning signs of emerging imbalance.

The second major difficulty in our present situation relates to the strength of the exchange rate. We are, of course, acutely aware of the problems that this is creating - and has been creating for the past year or so - for those sectors of the economy that are engaged in international trade and exposed to international competition. Given that the UK chemical industry exports nearly two thirds of its output, and that this country imports nearly 60% of the chemicals we consume, it is just possible that one or two of you are suffering from the strong exchange rate. I only ask you to believe that we both understand and share your concern. From a macro-economic standpoint it is - as I say - important that the pace of growth of aggregate demand should slacken. But it is clearly not desirable - either in terms of sustainability or in terms of the balance of the economy - that the slowdown should simply be a result of a sharp deterioration in our balance of payments. Our problem, potentially, is excess domestic demand.

And that is the root of the dilemma. We have needed to tighten policy to moderate the strength of domestic demand. That has no doubt contributed to the continuing strength of the exchange rate - although you can't plausibly explain anything like all of that strength in terms of relative interest rate movements here and abroad. It certainly has a good deal to do with market perceptions about the future strength of the euro.

We can, and have, and I hope will, take account of the exchange rate in our tactical approach to monetary policy. But with the best will in the world, what we cannot sensibly do, is to ignore the strength of domestic demand in order to shelter the exposed sectors. That would put the whole of the economy at risk to accelerating inflation - including those sectors we were seeking to protect. And it would not be of much help to them in anything other than the short term. The monetary policy option is - as I say - not whether or not, it is sooner or later, and ultimately less or more.

The elements of hope that I can hold out to you - and central bankers can never give guarantees on this kind of thing - are first, that as we move into the euro process the markets will become increasingly persuaded that the ECB will, in fact, be committed to the stability of the new currency, as I am sure it will: and, secondly, that relative monetary conditions will change as activity picks up on the Continent and domestic demand moderates in this country.

Our present exchange rate dilemma, Mr Chairman, illustrates rather well the conflicting arguments about the euro project itself.

The strengthening of sterling and its effect on the exposed sectors of the economy point up very vividly the very real advantages of the exchange rate certainty across the European Union area which only the euro can provide. If I were going through what many of you are now going through in your individual businesses, I think I would find the prospect of exchange rate certainty overwhelmingly attractive - given of course a reasonable starting point.

The potential downside, from a macro-economic standpoint, is that just as now directing monetary policy to lowering the exchange rate would mean losing control over domestic demand, so too, as a member of the euro area we might find that the single euro interest rate was not necessarily appropriate to our domestic situation. We would certainly be facing a build-up of excess demand, and inflationary pressure, now, for example, if we were constrained to German-level interest rates. At other times interest rates that were appropriate in Europe as a whole could impose unnecessary stagnation and rising unemployment in this country.

Serious divergence of this kind between the domestic monetary policy needs within the euro-area is not, of course, inevitable. But, if it is to be avoided it is important that the economies of the euro-member countries should have shown at least a minimum degree of sustainable convergence - before the project goes ahead. That was recognised very clearly in the famous convergence criteria written into the Maastricht Treaty.

Assessing the extent to which sustainable convergence has in fact been achieved is the unenviable task facing the European Finance Ministers and Heads of Government at their historic meeting at the beginning of May. Whatever they decide more widely, it is clear in my view that, for a number of reasons, including the cyclical differences between our situation and that on the Continent, we cannot now be confident that this country could live reasonably comfortably with a single European interest rate. That is why I welcomed the Government's decision last October to exercise, for the time being, our opt-out, but to plan the technical preparation for our future participation, when we are more confident that sustainable convergence has indeed been achieved.