BANK OF ENGLAND

Speech

Annual Cornwall Lecture

Speech given by

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Mr Chairman, Ladies and Gentlemen,

I am genuinely delighted to be with you all this evening - for three reasons.

First, is the huge pleasure of being once again in Cornwall. I have to tell you that whenever my wife and I come down here - and for the time being that's not as often as we'd like - we have a wonderful sense of relaxation. We often say that Cornwall smiles across the Tamar.

The second reason for being delighted to be here is that it gives me the opportunity to meet so many of the local community and to learn about the progress of your campaign "In pursuit of excellence". And the third reason is that it gives me the opportunity to explain to you what the Bank of England is trying to do, and how that can contribute to what you yourselves are working to achieve.

Let me begin with what we at the Bank are trying to do.

Most people know that the Bank these days has independent responsibility for the operation of monetary policy. That means, essentially responsibility for setting short term interest rates. We do this with the explicit objective - set by the Government - of achieving consistently low inflation, defined precisely as an inflation rate of 2½ % a year - on a measure of retail prices known as RPIX (ie… the familiar RPI less the effect of changes in mortgage interest payments). In terms of the standard European Union measure of retail price inflation this is equivalent to an inflation rate of some 1½ - 1¾ %.

Now many people assume that because our immediate objective is defined in terms of a low inflation target - we, and the Government, see consistently low inflation as an end in itself. But the reality is that none of us sees low inflation as an end in itself. We see it as a necessary means to the end of sustainable, (and I emphasise the word "sustainable") growth of output and employment and higher living standards in this country - which are, of course, what all of us are ultimately trying to achieve.

Let me try and explain.

Cutting through a lot of complication, inflation - a rising general price level - is essentially a result of overall demand in the economy outstripping the structural, supply-side, capacity of the economy as a whole to meet that demand. It is in fact a symptom of imbalance between overall demand and supply. So what in fact we are trying to do in aiming for consistently low inflation is to keep overall demand continuously broadly in line with supply-side capacity - not letting it run ahead of supply giving rise to increasing inflation, but not letting it fall short of supply either, which would put unwanted downward pressure on prices. So we are in fact using inflation essentially as a measure - a barometer if you like - of our success or failure in maintaining stability - or balance between demand and supply in the economy as a whole - in this much wider sense.

This represents a significant change in the approach to the macro-economic policy that was in effect pursued for much of the earlier post-war period in this country. All too often in the past both overall fiscal policy and monetary policy were used to pump up aggregate demand without sufficient regard to the supply-side constraints. What essentially we were trying to do then was to squeeze out a bit more growth and employment even at the expense of a bit more inflation. You all know the result - eventually inflation got out of hand and the economy had to be brought to a juddering halt. The go-stop policy cycle simply aggravated the boom-bust business cycle. That had painful social as well as economic consequences in the short run. But it equally had damaging longer run consequences, engendering a corrosive short-termism in both personal and business behaviour as we all tried to grab what we could during the upswing while the going was good. Worse even than that, the situation threatened to become explosive as the rate of inflation increased from cyclical peak to cyclical peak and the rate of unemployment rose from cyclical trough to cyclical trough.

Now we've learned from that experience. We've learned that there really is no trade-off between higher growth and employment on the one hand and higher inflation on the other except in the short term. We've learned the importance of sustained overall fiscal discipline into the medium and longer term if an excessive burden is not to be put on monetary policy. We've learned to direct monetary policy to shorter term stabilisation of demand relative to supply. And we've learned, finally, that it is the supply side of the economy that determines the underlying rate of growth that can be sustained. All of that is now common ground across a very broad part of the political spectrum in this country; and it is common ground across much of the rest of the world.

There were initially many who argued that low inflation could only be achieved and maintained at the expense of slow growth and high unemployment. Indeed there are still those who remain to be convinced. So let me give you some facts.

Since we first adopted an inflation target in this country towards the end of 1992, inflation on the target measure has averaged 2.7% the longest period of sustained low inflation certainly since the Second World War. Yet we are now in our 30 th successive quarter of continuous output growth since the upturn began, that's already the longest period of sustained quarter-by-quarter growth since the Quarterly National Accounts began in 1955. Output growth over this period has averaged 2¾% a year - which is ¼-½% above most people's estimate of the underlying trend rate of growth. Employment in the UK as a whole is at an all-time high. And the rate of unemployment is lower than it has been for very nearly 20 years. And that's also true for most of the individual regions of the country, including the South West, where the employment rate is in fact significantly higher, and the unemployment rate significantly lower on the latest data than the overall UK average. And it is almost certainly true here in Cornwall where, consistent data do not go back beyond the early 80s but where, on a seasonally adjusted basis, unemployment has fallen year by year since 1992, to below 5% in October, for the first time since this particular data series began. On this evidence I think it is more plausible to argue that the stability reflected in sustained low inflation has contributed to growth and employment than that it has been at the expense of growth and employment.

I am not suggesting, Mr Chairman, that we are in reach of Nirvana! I am acutely conscious of the fact that within this overall picture there are some sectors of the economy - pretty much the whole of agriculture, large parts of manufacturing industry, and some services sectors, including tourism, that have been, and indeed still are, under severe pressure. I am acutely conscious, too, of the effects of this pressure on some regions of the United Kingdom that are especially dependent upon those sectors. Their problems have been aggravated in many cases by the strength of our exchange rate. This strength has not been against the dollar -we've been really remarkably stable against the dollar in the past few years. Sterling has been strong first against the Eurozone currencies, reflecting the relative weakness until recently of the Eurozone economies; and it was subsequently affected by the collapse of both the currencies and domestic demand in many emerging countries as a result of the global financial and economic turmoil that threatened to engulf us all over the past couple of years.

We are only too well aware of these factors, which have had the effect of dampening overall demand and overall cost and price pressures in the UK. And we have, of course, taken them into account in reaching our monetary policy decisions over this period, effectively aiming to compensate for external weakness by stimulating domestic demand. Our dilemma has been that we could not have gone further in this direction and attempted to shelter particular internationally-exposed sectors, or regions, without the risk of destabilising the whole of the economy.

As it is we have been able to avoid the recession which was almost universally predicted in this country a year ago. World demand is now clearly recovering, including a pick up in the Eurozone, which may help to restore a better equilibrium in foreign exchange markets. And provided the strong growth of domestic demand now moderates somewhat, the broad prospect for the UK economy over the next couple of years is one of continuing relatively strong growth overall with continuing relatively low inflation. The uncertainties - and there are of course always uncertainties - are by and large matters of degree, affecting the precise relationship between demand pressure and its impact on costs and prices. They relate to just how strongly the economy will grow and just how low inflation will remain - rather than to the overall picture.

I hope you would at least agree that the overall economic prospect I have described is an encouraging background to what you are trying to do down here in Cornwall. It is in fact the best help we can give through monetary policy. We operate, as I say on the demand side of the economy, and we can, and hopefully will keep aggregate demand, nationally, growing broadly in line with the growth in our supply-side capacity. We can't frankly do much directly - with one exception that I will come on to in a moment - to affect the supply side. But by maintaining stability in this sense, sustaining low inflation by moderating rather than by aggravating the inevitable ups and downs of the business cycle, we can create an environment which encourages more rational, longer-term, decision-making throughout the economy, based upon real factors, rather than speculative, nominal, factors; and that can contribute to improvement of the supply-side indirectly.

Let me now turn to the supply side of the economy - and begin with the one area where the Bank can play a role, and that is by helping to improve the effectiveness of the provision of finance, particularly to the small and medium-sized business sectors of the economy, the SME sector, which I know is of particular importance here in Cornwall.

Defined as businesses employing less than 250 people, the extraordinarily diverse SME sector comprises some 3.7 million individual enterprises in the UK, operating in every sector of economic activity from handicraft to the highest technology companies, with business objectives ranging from maintaining a particular lifestyle to becoming the next generation of global company. Between them SMEs account for over 60% of both employment and output. And within the sector some 3 1/2 million micro-businesses, those employing up to 10 people, account for about 30% of total employment and 25% of total output. I believe that in Cornwall SMEs account for over 80% of employment.

But the importance of the sector lies not just in its size or its contribution to employment. It lies too in its particular capacity for specialisation, and its related ability to respond innovatively, quickly and sensitively to the needs of the marketplace. And that adaptability and flexibility is crucially important not just to the individual business, but to the strength of the economy as a whole in today's world of continuous, rapid, change.

At the time of the recession at the beginning of the 1990s there was a serious breakdown of communication and confidence between very many SMEs and their main finance providers, notably the commercial banks. The borrowers complained bitterly that the banks cut back on their loans just when they needed their support most; while the banks for their part, suffered very large losses on loans that they were unable to recover. The real culprit of course was the exaggerated boom/bust cycle for which we, the authorities, must bear responsibility. But whatever the history there was a clear need to restore a better relationship between the two sides.

The Bank's part in this process has been essentially to organise a more effective dialogue. Since 1992 we have held regular consultations with the SME community, through their various representative organisations and through direct contact - both from London and through our regional agents all around the UK. We have had regular consultations on SME financing, too, with the individual banks. And then we've brought the two sides together, with some key academic experts for an annual symposium.

That process has enabled us to monitor the relationship between borrowers and lenders. It was not of course to be expected that things would improve dramatically overnight. Given the huge diversity and complexity of the SME sector, what we were looking for was incremental progress across a broad front rather than some kind of single solution. And that indeed is what we have seen.

The banks have devoted considerable efforts to understanding the different financing needs of their SME customers, helping to reduce their own lending risks in the process. This is reflected, for example, in a fall in the proportion of SME finance accounted for by traditional bank borrowing (from 61% in 1987-90 to 47% by 1995-97); it is reflected too in a shift away from short-term lending towards term finance, which now accounts for just over 70% of the total; and 34% of this term lending is now at fixed rates of interest, compared with 28% in 1996. There is less emphasis on collateral and more on the progress of the business. And leasing and receivables financing has risen (from 22% in 1987-90 to 33% in 1995-97).

As the banks' understanding of the needs of their customers has improved, so too the SME community has developed a better understanding of the banks' need for up-to-date financial information and early warning if things start to go wrong. At our last symposium in January this year, the British Chamber of Commerce, for example, reported on research showing that 87% of their respondents now find their bank to be supportive. And the Forum of Private Business reported that its aggregate bank performance index had improved by about 10 percentage points since 1992 - and they found that SMEs which had developed a more participative relationship with their banks, including a better two-way information flow, were benefiting from lower charges and collateral requirements.

Overall, Chairman, it was clear last January - and remember that almost everyone was fearful of recession at that time - that both the banks and the SMEs were much more comfortable in their relationships and felt much less vulnerable to an economic downturn if that were to occur. We will, of course, continue to maintain this dialogue and look for continuing improvement; and in this connection I know that John Beverly, who has recently moved to become the Bank's Agent for the South West; and who is here this evening, will be interested to learn of your experience. But on the whole things seem to be much better than they were. We are now extending our effort in relation to debt financing to exploring particular problems, for example, in relation to start-up and early-stage finance for disadvantaged groups in low income communities, and in relation to ethnic minority businesses.

We will, as I say, continue to work away at improving access to debt financing, but increasingly over the past 2-3 years attention has focussed - as perhaps I should say refocused because it is a very long-standing issue - on the different question of access to equity financing.

Many, particularly family-owned, businesses are in fact reluctant to take in external equity, because they prefer to maintain independence or are not looking to expand. But it is very important for the economy as a whole that we should nevertheless provide effective mechanisms to enable companies that do need it to have access to equity, especially because these companies typically include the younger, growth-oriented businesses, not least those in the high-tech sectors.

Here, too, the questions are as varied and diverse as the SME sector itself. They include everything from the development of "business angel" networks at one end, through more formal venture capital provision, to the respective roles of private and public equity at the other. Again, we are not looking for a single magic solution. We need to continue to explore right across the spectrum the role of the businesses themselves in providing accessible information to potential investors. We need to explore the role of investors, ranging from private, often local, investors to the large professional investment fund managers and their actuaries and trustees. And we need to explore the role of intermediaries, including financial advisers but also trading networks and exchanges. Many aspects of this subject are already being - or have indeed already been - examined by the Government, the Bank and private sector financial bodies working together with representatives of SMEs, and it will be a main focus of the Bank's next annual report on SME finance to be published early next year.

In general, there is no doubt that the importance of the SME sector to the supply side of the economy is now much more widely appreciated and it has moved up the policy agenda - not only in the context of the provision of SME finance but more broadly. To the extent that we can strengthen the supply side in this way it will make for a more robust economy and make our monetary policy job on the demand side that much easier. It would also be particularly good for Cornwall.

But the need for strengthening the supply side of the economy is not, of course, just a matter of improving access to SME finance. So let me conclude with a few general remarks on improving the supply side - with particular reference to Cornwall.

A major impetus for improving the structural, supply-side, capacity of the economy as a whole, of course, comes from Government policy. This includes everything from policies to promote domestic and international competition. It includes privatisation - to bring market pressures to bear on improving the efficiency of commercial activities previously undertaken within the public sector. It includes every aspect of budgetary policy - from expenditure on education and training, or business support, for example, to welfare reform affecting incentives to work, or tax policies affecting the cost of employment or incentives to enterprise. It includes regulatory policies and the associated costs of compliance. It includes labour market policies and so on almost endlessly. I'm happy to say that these are decisions for politicians who often have to make extraordinarily difficult judgments to reconcile perceived conflicts between social and economic objectives. But we have in fact in this country made considerable progress on supply-side reform in recent years - which helps to explain why we have been able to sustain the economic expansion and growth of employment for so long without more inflationary pressure.

Closer to home, SWERDA published its Economic Strategy at the end of last month, setting challenging objectives to improve business competitiveness, to address social and economic imbalance and to improve regional cohesion. It identifies the key "strategic drivers" as: innovation and technology, skills and learning;

the regional environment; and partnership. And, of course, you will now benefit, too, from Objective One status within the European Union and the associated flow of funds which will start next year.

But ultimately what you achieve in improving the supply-side of the Cornish economy, and in raising income levels, depends above all upon you yourselves. And I have been deeply impressed by all that I have heard and read about your collective efforts in this respect.

You have deep-rooted traditions and you have experienced the long-term decline of important local industries over a long period. The temptation against that background particularly is to look back to the past - to try to hold on to what you have had. But everything that I see - in the Objective One program document, in the publications of the "In pursuit of excellence Cornwall" partnership, in the "Agenda" document put out by the Federation of Small Business in Cornwall, in the regeneration project for Camborne, Pool and Redruth led by John Rose and Business in the Community - to take just a few examples - everything I see clearly puts the emphasis on looking forward to new challenges and new opportunities. It puts emphasis, too, on co-operation - between business and the community, between business and education, and between the private and the public sectors. These approaches it seems to me are the foundations for success.

They can help you to build upon your comparative advantages - above all the character and inventiveness of the Cornish people and the attractions of Cornwall as a place to live and as place to visit. They can help you to overcome the skills shortages you have suffered from in the past - by focussing particularly on education. I think of the Combined Universities in Cornwall project, the Camborne School of Mines, the Falmouth College of Arts, or the Duchy of Cornwall Education Awards. And education in turn can help you to overcome the disadvantage of peripherality - to take advantage of the new technology - which, as Ian Vallance, Chairman of BT, suggests in the Green Book, means that "distance is no longer a business problem". Much is already underway in Cornwall - and there's a real sense of excitement and enthusiasm. And when I see Dun and Bradstreet earlier this year putting you up to 3rd place (from 18th) in the list of counties ranked by the proportion of profitable businesses, behind only Renfrewshire and West Lothian - though I'm not quite sure what it means - it can only suggest that you are already well on the road to success!

Mr Chairman, with the prospect of a stable macro-economic environment, with national and regional policies encouraging supply-side flexibility, with this clear evidence of your own determination to up-rate the Cornish economy I have no doubt that you have a prosperous future ahead as we move into the next millennium. I only look forward to the time when I will be able to share that future with you.