BANK OF ENGLAND

Speech

Birmingham City 2000

Speech given by

Edward George, Governor of the Bank of England

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Thank you, Mr Chairman. I am delighted to have been invited to speak at this Birmingham City 2000 Dinner on the evening before the first ever meeting of the Court of Directors of the Bank of England at one of our Regional Agencies. We have decided to hold Court meetings periodically outside London for two reasons. First, we want to emphasise that we are the central bank for the whole of the United Kingdom and that we are very sensitive to that responsibility. Secondly, we want to draw attention to the existence of our twelve existing regional agencies (and, as we announced on Monday, we will shortly be opening a further agency in Northern Ireland) and to the important role which they play in informing the monetary policy process in particular of real-world conditions on the ground in industry and commerce in every part of the United Kingdom.

Our Agent here in the West Midlands, John Beverly, is well known to many of you. He will be moving on, to the South West, in the autumn to be replaced by another John! John Bartlett who is at present a Deputy Chief Cashier. I am sure you will quickly get to know him just as well – and I am equally sure that he will represent your various views on the business conditions here in the region to the Monetary Policy Committee just as objectively and forcefully as John Beverly has done. I'd like to thank John publicly this evening for all his work, on both your and our behalf, over the past three years.

I thought that in my opening remarks I would talk about the state of the economy as a whole, about the substantial imbalance between the domestic and the internationally–exposed sectors of the economy and the regional impact of that imbalance, and about the difficult dilemma which that poses for monetary policy. I will then happily try to answer your questions.

Let me start then with the overall economy. The economy as a whole has grown consistently quarter by quarter now for over seven years – at an average annual rate of 3.2% which is well above its long-term trend rate. Consumer price inflation has averaged some 2.7% over this period. Employment has risen to a record level; and the rate of unemployment has fallen to a near 30 year low. All of that is very encouraging.

But since the summer of 1996 our effective exchange rate has appreciated by about 12% and we have been affected by a global economic slowdown resulting largely from the financial crisis that began in Asia two years ago. As a result our trade balance with the rest of the world has deteriorated – by some 1¼% of total GDP between 1997 and 1998; employment in manufacturing has fallen by around 2% since the beginning of last year; and business confidence fell sharply to levels last seen in the depths of recession – until it stabilised following interest rate cuts in the autumn, albeit to levels which are almost twice as high as those in the Eurozone.

Now you could be forgiven if you thought that all that was me describing the UK economy to an audience in Birmingham, England. In fact it is what my counterpart, Alan Greenspan, might well have said if he were addressing his fellow Americans this evening in Birmingham, Alabama, on the 'Goldilocks' economy of the

United States! I tease you in this way to make the serious point that we are not alone in facing substantial imbalance within an economy that is performing reasonably well in overall terms.

In the case of the United Kingdom – and I'm being serious now – the facts are that the economy as a whole has grown consistently for 27 consecutive quarters – though I admit that during the last six months it was a 'damned close run thing' – at an average annual rate of 2.9%, which is well above its long-term trend rate of around 2¼ %. Consumer price inflation – on the Government's target measure - has averaged some 2.8% over this period – or 2.2% measured in terms of the European Harmonised Index of Consumer Prices. Employment has risen to an all-time high; and the rate of unemployment – despite a very small rise over the past couple of months – is still close to a 20 year low. And all of that, too, is very encouraging.

But, beginning in the autumn of 1996, our effective exchange rate suddenly appreciated, by almost 25% a year or so later. To complete the parallel with the US data, our trade balance with the rest of the world deteriorated – by 1¾% of GDP between 1997 and 1998 – business confidence fell back in the Autumn to levels last seen in 1990, and employment in manufacturing has fallen by 3.3% since the beginning of 1998.

Sterling's appreciation – largely against the core European currencies – was difficult to explain in terms of relative monetary conditions and appeared to have more to do with market uncertainty about the prospects for the euro. But, whatever the cause, it seriously complicated our task of monetary management by creating a suddenly much harsher business environment for many of the internationally exposed sectors of the economy – including parts of industry, but also much of agriculture and some of the services sectors. Domestic demand, on the other hand, was growing strongly, so strongly in fact that we faced the danger of overheating in the economy as a whole despite the dampening effect of the appreciation on domestic costs and prices and despite the restraining effect on aggregate demand of the prospective worsening of the external trade balance. That was the background to the tightening of monetary policy from the middle of 1997 designed to moderate the pace of overall demand growth. We were of course well aware of the pressures on the internationally exposed sectors, and we made full allowance for the twin effects of the strong exchange rate on the price level and on aggregate demand in making our projections of future inflation. But if we had held off from tightening policy to moderate the pace of the overall expansion at that stage – in order to try to protect the exposed sectors – the chances were that inflation would have accelerated, and that we would then eventually have had to bring the economy as a whole to an abrupt standstill in order to bring inflation back under control. That would not have helped anybody.

By the late summer of last year these conflicting pressures in the economy appeared to be beginning to ease. Domestic demand growth was indeed moderating – as it needed to do; and the exaggerated strength of sterling's exchange rate was diminishing as the approach of the introduction of the euro appeared to generate increased confidence in the new currency.

But we were all then hit by new shocks to the world economy. Russian default, followed by the near collapse of a highly-geared US hedge fund, led to a flight of investment into only the most secure and highly liquid assets, threatening not only a new round of financial crises in the emerging markets of Asia, Latin America and elsewhere, but also, for the first time, a credit crunch in major industrial economies, most notably in the US. Meanwhile the Japanese economy remained independently mired in recession.

By the time of the annual IMF meetings in Washington last October the public atmosphere was close to panic and the media noise was of impending world recession. Business confidence slumped pretty well everywhere, and so too in this country did consumer confidence. We were faced in the Monetary Policy Committee with a situation in which the overall economic slowdown which we had been seeking to engineer, in order to prevent accelerating inflation, threatened to become an unnecessary economic downturn likely to produce an unwanted fall in the rate of inflation to significantly below the Government's 2½% inflation target.

At the Trades Union Congress in Blackpool last September I had emphasised that our inflation objective was symmetrical, and promised that if overall demand threatened to fall significantly below the supply capacity of the economy, with the risk that we would fall short of the inflation target, then we would be just as vigorous in reducing interest rates to stimulate demand as we had been in raising them when the risks to inflation were on the upside. So, in the new situation, the Monetary Policy Committee promptly reversed engines to pump up demand, cutting rates by 2¼% over the next few months to as low as they have been since 1971. (This relatively aggressive response was not incidentally – as is sometimes suggested – a sudden conversion to a more activist philosophy, simply a reflection of the rapid decline in the economic prospect which required a strong response.)

Since last autumn the world financial and economic situation has certainly stabilised under the impact of the continuing strength of domestic demand in the US economy and of the beginnings of export-led recovery in a number of emerging markets, particularly in Asia. And world commodity prices, notably the price of oil, have shown signs of strengthening. But global imbalance seems likely to persist for some time, with domestic demand growth still relatively sluggish in Japan, and in the Eurozone taken as a whole. This imbalance, in turn, is a significant influence on the international pattern of interest and exchange rates. It is hugely important for the future strength of the world economy that as domestic demand growth in the US moderates – as it almost certainly will, one way or another – domestic demand growth in the other industrial countries accelerates to take up the slack.

Here in the UK both business and consumer confidence have improved since the autumn and overall output growth seems set to recover, on the back of accelerating domestic demand growth, to around its long term trend by about the middle of next year. But we, too, are having to continue to cope with the imbalance between the domestic and internationally exposed sectors of the economy as a result of continuing relative demand weakness in some key overseas markets and of relative price effects resulting from a renewed rise in the exchange rate, which, despite the sharp reduction in interest rates, has strengthened against the euro since the beginning of this year. These external factors will have a continuing dampening impact on our domestic inflation rate – which is likely to remain close either side of the inflation target. Overall then, although the prospect is for renewed growth with continuing low inflation over the next couple of years, the tension between the different sectors of our economy has not for the time being disappeared.

Against the background of that brief description of recent and prospective developments in the economy, let me now try to draw out what we can, and what we cannot, hope to achieve through monetary policy.

Monetary policy operates on the demand side of the economy, and essentially what we can hope to do – and what we are aiming to do - is to keep overall demand broadly and continuously in line with the underlying supply-side capacity of the economy to meet that demand. How close we come – on average and over time – to meeting the 2½% inflation target is in effect simply a measure of our success in achieving macro-economic stability in this wider sense.

We cannot directly affect supply-side capacity – the underlying rate of growth that we can expect to sustain. But, by operating symmetrically – as we have shown that we do – we can provide an environment in which supply-side improvements (for example, more rapid productivity growth which apparently explains the stronger performance of the US economy in the past few years, but which we have yet to see in this country on anything like the same scale) have the best chance of feeding through into faster sustained output growth. And, to the extent that we are successful in maintaining macro-economic stability, that can help to improve our supply-side performance indirectly by lowering real long-term interest rates and encouraging better decision–making in the economy as a whole with less distortion from unnecessary erratic movements, particularly in nominal values.

But we can only hope to maintain macro-economic stability for the economy as a whole. What we cannot hope to do is to provide an equally stable environment for every sector of the economy or for every business enterprise, nor therefore can we hope to maintain a stable environment for those regions of the country with heavy concentrations of particular sectors or businesses.

We cannot hope, for example, nor should we seek, to obstruct structural change. Consumer demands change over time, and so, too, do technologies and management and production techniques. Competition, to seek out such changes and to exploit them to meet social needs more efficiently – however unwelcome it may be to establish producers – is a vital driver of supply-side improvement, increasing the potentially sustainable growth rate at the macro-economic level from which we all stand to benefit.

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 - though we can aim to moderate their impact rather than exaggerate it as we have done at times in the past.

Nor, finally, can we hope to insulate ourselves from shocks originating overseas. That does not mean that we do not understand the painful impact of the recent state of the world economy or of the strong exchange rate. Nor does it mean that we simply ignore the plight of the adversely affected sectors. We are concerned – as you are – with the health of every sector of the economy, we fully appreciate the interdependence of the different sectors, and we well understand the part that greater real exchange rate stability can play in promoting more balanced economic growth. But the harsh reality is that we could only seek to achieve a particular exchange rate in order to protect the internationally exposed sectors at the risk of destabilising the economy as a whole, and there would – as we have recently seen – be no assurance even so that we would be successful in achieving and maintaining a particular exchange rate. We do, as I say, take full account of the impact of world demand and of the exchange rate on the likely path of inflation, and, to the extent that these influences are exerting a disinflationary effect, interest rates are lower than would otherwise be the case. That was the reality behind the statement made after our last MPC meeting that if the exchange rate does not decline from its present high level, as we assume that it will, at least in line with interest rate differentials, then, depending on other developments in the economy, there might need to be further easing of interest rates to keep inflation on track. I stand by that today.

But let me be quite clear. This does not mean that we have any particular target for the exchange rate. Nor can it mean that we set interest rates simply by reference to those prevailing elsewhere. It is naïve to complain that our interest rates are twice those in Europe without recognising that we are operating closer to capacity than is the case in the Eurozone as a whole – or that unemployment there is running at twice the rate in this country even if – and I agree – much of that difference is to be explained by structural, supply-side, rigidities rather than simply cyclical divergence.

No-one, Mr Chairman, is more conscious of the limits to what we can hope to achieve through monetary policy than I am. But operating within those limits, we have been able to achieve greater macro-economic stability, reflected in the rate of inflation, than we have seen for a generation. And that stability, together with the improved supply-side flexibility of the economy, has delivered a rate of unemployment in the economy as a whole that, despite the recent modest upturn, is still close to the lowest rate we have seen in almost 20 years. And what is true for the UK as a whole is true for most of the individual regions of the economy. That includes the West Midlands, where, on a claimant count basis, unemployment at 4.8% is actually only marginally above the national average and still just about the lowest it has been since 1980.

Macro-economic stability cannot solve all our problems. But it can certainly help, and is in fact the best contribution that monetary policy can make to the sustained growth of output, high levels of employment, and rising living standards. It helps particularly where there is supply-side flexibility and sectoral diversification. Birmingham, and the West Midlands more generally, have made – and are making – considerable strides in those directions, building on existing strengths certainly but also developing new skills and new activities. Birmingham City 2000 has, I know, played an important role in this forward-looking approach. I congratulate you and encourage you to persist in your endeavours – in conjunction with the West Midlands Regional Development Agency – well into the next millennium, despite your apparently non–Y2K–compliant title.