BANK OF ENGLAND

Speech

Speech by the Governor at the Bankers Club Annual Banquet

Speech given by

Edward George, Governor of the Bank of England

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I should like to add my personal thanks to you, Jean-Claude [Trichet], for joining us this evening, and for the elegant way in which you have addressed us. Your presence with us so soon after the introduction of the Euro could not be more appropriate because few people have done more to bring about that historic achievement.

I fully share your confidence that the new currency will be successful in the sense that the Euro will become a robust and widely-used international trading, portfolio, and reserve, currency - alongside the dollar.

A necessary condition for that is the integration of Europe's financial markets. In this connection the years of technical preparation, and the implementation of the transition to the Euro over the year end, were a triumph - right across Europe, including here in the United Kingdom.

That is a great tribute to Europe's central banks - including the ECB. But it is a great tribute, too, to the dedication, commitment and professionalism of the many thousands of market participants across Europe who played their part in this extraordinary achievement - including those here in the City. Many of you are present this evening and I congratulate you.

The essential Euro payments and settlements, and market, infrastructure is now demonstrably in place. It is the foundation upon which broader and more liquid, truly pan-European, markets in Euro instruments can now be built - and we are already seeing the beginning of that process. It will be driven by increased competition between financial businesses, operating both within and across financial centres. That in turn will bring increasing benefits to the users of financial services in Euro in terms of liquidity and innovation - whether simply for transactions, or as borrowers, or lenders or investors. And these benefits will encourage increasing use of the Euro, which will provide great opportunities for Europe's financial services industry as a whole. Competition in this field, as in other fields, is a positive not a zero sum game at the aggregate level. I know that all of you who are active here in London are not only ready for, but positively looking forward to, the challenge - and to continuing in this way to make a major contribution to the Euro's success.

The second condition for that success is that the Euro should be reliably managed. And I share your confidence, Monsieur le Gouverneur, in this context, too. We have I believe the same basic philosophy. The members of the Governing Council of the ECB - individually and collectively - are committed to the view that effective price stability is a necessary condition for the sustainable growth of output and employment. So, too, are we in this country. In this sense price stability is not simply an end in itself. Our aim, like yours in the Eurozone, is to keep aggregate demand in the economy broadly and more or less continuously in line with the underlying capacity of the economy to meet that demand. Consistently low inflation is the measure of our success in achieving that wider aim.

There is not much that either of us can do through monetary policy directly to affect the underlying rate of growth of productive capacity. That is determined essentially by the structural, supply-side, characteristics of the economy.

Demand management, including monetary policy, cannot substitute for the structural reforms that are needed to improve the flexibility with which the economy as a whole responds to change. But we can, through monetary policy, aim to create an environment of stability - avoiding either excessive or deficient demand. That is the best help that we can give to the more effective performance of the economy. And it is the most effective thing that we can do to bring about reasonable exchange rate stability over time against the currencies of the other countries pursuing similar objectives. By the same token, the parallel pursuit of effective price stability in this country and in the Eurozone is the best contribution that monetary policy can make to sustainable convergence between our respective economies and to improving the prospect of our own eventual adherence to Europe's Monetary Union.

But the fact that we have permanent effective price stability in common, as the immediate objective of monetary policy, does not make it technically any easier to achieve. Assessing the prospective pressure of demand is extraordinarily difficult at the best of times. It is especially difficult at the present time as a result of the uncertainties created by the recent turbulence in the world's financial markets.

As a measure of that turbulence, the Institute of International Finance recently published data which show that total net private capital flows to the emerging markets fell from some $325bn in 1996 to around $150bn last year. I hope it's not too indelicate in present company to mention that well over two thirds of this decline (some $130bn out of around $175bn) was a result of a reversal in the position of commercial bank lenders - from net credit extension to the emerging markets of $120bn, to net credit contraction of some $10bn. Non-bank lending and portfolio equity inflows also fell back by about $60bn (to around $50bn). And although direct investment in the emerging markets held up pretty well (at around $100bn), and despite a big increase of nearly $50bn in official lending, there was a sudden, huge, decline in the overall availability of finance to the emerging markets, leaving many of them with sharply weakening exchange rates and little choice but to contract their domestic economies.

The immediate international priority was to contain the financial contagion - and there was some progress in this direction following the initial shocks in Asia. But after a series of new shocks during the summer - Russia, LTCM, the deepening recession in Japan and the worsening position in Brazil - the prospects, at around the time of the IMF meeting in Washington last autumn, were looking pretty bleak, and the atmosphere among commercial and investment bankers - particularly in the US - was as nervous as I can remember.

Now you will rarely hear a central banker predicting fine weather - and I have no intention of breaking that convention this evening. But the darkest storm clouds have lifted a little since the Fund meeting. The US

Congress finally approved more resources for the IMF, the threat of a credit crunch extending to the industrial economies in the wake of LTCM receded, helped also by an easing of monetary policy in Europe as well as in the United States. In Asia, Japan took more determined policy action to address the fragility of the banking system and to stimulate domestic demand; the Yen strengthened; China and Hong Kong both remained admirably resolute; and there have even been some encouraging signs of renewed capital inflows to some countries. And we at least bought time in Brazil so that when the exchange rate finally floated the markets elsewhere reacted with something approaching relief.

It's much too soon to declare victory - there may be further particular setbacks. Vigilance remains the watchword. But the risks of general, widespread, international financial disturbance have certainly receded since the autumn.

But we are now having to cope with the economic consequences of the earlier financial disturbances. The inevitable counterpart of recession in much of the rest of the world is a sharp slowdown of net external demand - particularly for manufactures - in the industrial world. That has been reflected in growing weakness and falling business confidence in large parts of the manufacturing sector in both the United States and Europe. The prospect for growth in world economic activity has already roughly halved - from its trend rate of around 4%. And unless this fall in net external demand is offset by stronger domestic demand growth in the industrial counties - unless, in other words, the industrial economies collectively accommodate the necessary improvement in the external current account position of the emerging countries through a deterioration in their own current account positions - the prospect for world economic activity would be dismal.

Happily we start from a position of relatively low inflation throughout the industrial world, and faced with weakening external demand we can afford to see higher offsetting domestic demand growth without jeopardising price stability. Indeed we need to see higher domestic demand growth than we would otherwise if overall demand is not to fall short of underlying supply-side capacity, so exerting an unnecessary and unwanted further downward pressure on domestic prices. We need it, too, to offset the effects of weak world prices and of lower exchange rates in many emerging market producers on our own domestic price level.

These considerations largely explain the easing of monetary policy in the US and in Europe since last autumn. The fact that we reduced interest rates by different amounts, and that they remain at different levels, is explained by differing assessments of the prospective impact on the pressure of overall demand, taking account of our own particular domestic starting points. But the general nature of the response was driven by essentially similar considerations.

Making those assessments is, of course, technically even more difficult than it usually is in the present conditions of imbalance between external and domestic demand, and of related differences between demand conditions confronting the different sectors and regions of our economies. All that we can realistically attempt to do is continuously to reassess the aggregate prospects for our separate economies as a whole in the light of the continual stream of new information. In that light we must be prepared to contemplate the further easing of monetary policy if overall demand seems likely to fall short of what we had previously anticipated, or, in due course, to move to tighten policy if domestic demand grows too rapidly or eventually as the world economy begins to recover. It's a pretty tough time for central bankers, Mr President, and I can almost begin to understand why Rossini's Gouverneur spoke of his "maudit emploi" - almost!

I recognise of course, Mr President, that it's a pretty tough time too for commercial bankers - though as I look around me you do not look any the worse for it all. You, too, obviously have strong nerves - and you may well need them in the year ahead. But think of it this way. By the time we next meet together for this great annual occasion Y2K will be behind you and if you have survived that you can survive anything!

It is in that spirit - the spirit of survival - that I ask you all to rise and to join me in a toast to the Bankers Club and to its President, Sir Patrick Gillam.

The Bankers Club and Sir Patrick Gillam.