BANK OF ENGLAND

Speech

Mansion House Speech

Speech given by

Edward George, Governor of the Bank of England

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My Lord Mayor, Mr Chancellor, My Lords, Aldermen, Mr Recorder, Sheriffs, Ladies and Gentlemen.

When we were last here for this splendid occasion I suggested that we were living in a dangerous international financial and economic environment. These were strong words for a central banker - but perhaps not strong enough. That environment rapidly became worse through the autumn, so that by around the time of the IMF Annual Meetings in October there was a good deal of talk about global financial meltdown and impending world recession - which was not simply journalistic hyperbole.

Since that low point things have certainly improved. The hectic scramble for financial asset quality and liquidity following Russia's default and the near collapse of LTCM - an exceptionally highly geared hedge fund - failed to uncover fatal weaknesses elsewhere in the financial system, and lenders and investors have gradually regained some of their appetite for risk. Fears of a general credit crunch in major industrial countries quickly receded; and sentiment towards the emerging markets has improved, with growing evidence of recovery in the original Asian crisis countries and a better than expected outcome in Brazil. Among the industrial countries, Japan made stronger efforts to bring its long recession to an end - through macro-economic stimulus and by strengthening its domestic banking system - and there are now signs that those efforts are beginning to be rewarded. Meanwhile the world economy has been effectively underpinned by continuing abnormally strong domestic demand growth in the United States.

But despite these developments we still have a long way to go. If the immediate danger of global financial instability has receded, we are still stuck with slow growth in the world economy, currently at around 2½% which is not much more than half the estimated trend growth rate. And we are stuck, too, with massive international imbalances, both between the emerging and industrial countries, on the one hand, and among the major industrial countries, on the other.

Without a stronger resumption of capital inflows to the emerging markets, the industrial countries will need to accommodate an export-led recovery in those markets. That implies stronger domestic demand, and hence import, growth in the G7 countries, if the world economy as a whole is to get back on trend in the reasonably near term. And the immediate challenge in this situation is to try to ensure that, as domestic demand growth in the United States slows - as it probably must, by one means or another - demand picks up sufficiently elsewhere, especially in Europe and Japan, to take up the running. That in turn will largely determine how successfully we can achieve an orderly unwinding of the present imbalances.

This wider international context is, inevitably, having a profound - and continuing - effect on the pattern of interest rates and exchange rates, and on economic developments, both within the Eurozone and here in the United Kingdom, to an extent that is still perhaps not fully appreciated.

A year ago, when the historic decision to go ahead with a broadly-based euro was taken in Brussels, the prospect was for a steady pick up in overall demand and output across the Eurozone. It was a helpful environment for the introduction of the new currency. And the constituent currencies of the euro strengthened in the second half of last year on the back of that.

The introduction of the euro at the beginning of this year was a technical triumph - within the Eurozone, but also notably here in the City, which has clearly established itself from the outset as a vital contributor to the development of broad and liquid euro-denominated wholesale financial markets.

But the growing impact of the global economic setback last autumn was to dampen external demand and business confidence in the Eurozone - as it did elsewhere - apparently affecting some of the participating countries more than others. In contrast to the United States, slower growth of external demand was not sufficiently offset by stronger domestic demand growth in the Eurozone, so that, instead of the expected pick-up in overall output growth, activity in fact increased progressively more slowly. Largely as a result, the euro has depreciated in the foreign exchange market and economic performance in individual participating countries has diverged more than might have been expected. This has been a disappointment to some proponents of the euro and has been seized upon by euro-sceptics as evidence of its risks. We need to be cautious, in my view, in interpreting this initial experience in the present unusually difficult global economic environment. As demand strengthens in the Eurozone - and the latest indicators from Germany are more encouraging - the likelihood is that the euro will recover and some of the present tensions ease. It has always been clear that there are potential risks of economic divergence within the Euro area to be weighed against the more obvious potential economic benefits of the single currency. The question has been just how significant are those risks likely to be. That will, ultimately, always be a matter of judgement. But it would be premature, in my view, to reach that judgement based on today's abnormal circumstances.

Now we, in this country, have of course been battered about, like everyone else, by the global turbulence. There is no way that we could have avoided its impact - either through fiscal or monetary policy. We are an integral part of the global economy.

And we had particular problems of our own. In our case, in marked contrast to the Eurozone, and despite the dampening effect of an already exaggeratedly strong exchange rate, we were confronted, in the early part of last year, with the prospect of excess demand and accelerating inflation, and policy had been tightened to head that off. But we, like others, were then hit in the autumn by the renewed turmoil in the global economy. That caused a sharper fall in external demand, but it also caused both business and consumer confidence to plummet - so that prospect of moderate overall slowdown we'd been deliberately trying to engineer quite suddenly threatened to turn into an unnecessarily sharp downturn , with the risk that the rate of inflation would fall significantly below the Government's 2½% inflation target.

So we promptly reversed gear - cutting interest rates very sharply - by 2½% to as low as they have been since the mid-1960's. That has helped both business and consumer confidence to recover - from very low levels - and the prospect now is that, after a pretty flat economic performance either side of the year end, overall demand and output growth will pick up steadily to around trend by the middle of next year. But, despite these interest rate cuts, the pound has actually strengthened - notably against the euro - in part, as I suggested earlier, because of weaker overall demand pressure on the Continent. So we are again impaled on the horns of our earlier dilemma, arising from continuing imbalance between the stronger domestic and weaker externally-exposed sectors of the economy. Believe me - it is not a comfortable place to be.

The question is what to do?

Of course, as with everything else, where you stand depends on where you sit.

The suffering sectors - most of agriculture, large parts of manufacturing industry and some services sectors - are in no doubt. Cut interest rates again - they say - and again and again. They're still twice as high as interest rates in Europe - and they might just as well add, they are over 150 times as high as interest rates in Japan! The many more net savers - including pensioners living off the interest on their savings - take the opposite view, although they do of course, benefit from the low inflation environment through the protection it gives to the real value of their assets.

What we have to try to do is to maintain stability in the economy as a whole , by keeping overall demand continuously broadly in line with the supply-side capacity of the economy as a whole . The inflation target is not some abstract end in itself - it is the measure, or barometer if you like, of how successfully we are managing to maintain macro-economic stability in the economy as a whole in this much wider sense. The reason that our interest rates remain higher than those in the Eurozone is that, despite the recent slowdown, our economy is operating closer to capacity than theirs. That's partly why our rate of unemployment is almost half theirs - though the greater structural flexibility of the British economy is even more important in this context.

The MPC sets interest rates to achieve the inflation target. We have made it clear by our actions that we are just as vigorous in relaxing policy when the risks to inflation are on the downside as we are in tightening policy when the risks to inflation are on the upside. That's the best help that we can give through monetary policy.

It does not mean that we ignore the external pressures. In assessing the prospects for the overall economy, and for inflation, we take full account of the impact of world demand and of the exchange rate, just as we take full account of all the domestic factors bearing on inflation prospects. When, as now, the external influences are having a powerful disinflationary effect, monetary policy is of course easier, and interest rates lower, than they would otherwise be. That does not - and cannot - mean that we are able to pursue any particular objective with regard to the exchange rate - or that we respond, Pavlov-like, to exchange rate fluctuations. But we can, and do, aim to offset the impact of persistent external influences on the prospect for inflation so that inflation in the economy as a whole stays on track to meet the inflation target given to us by the Chancellor. That is what we have been doing - and is the context of our further move today.

No-one, my Lord Mayor, is more conscious than I am of the limits to what we can hope to achieve through monetary policy. But by operating within those limits we have been able to achieve greater macro-economic stability, and consistently lower inflation, than we've seen for a generation. And that stability together with the improved supply-side flexibility of the economy, has delivered our highest ever level of employment, and a rate of unemployment in the economy as a whole that is still close to its lowest for almost 20 years.