BANK OF ENGLAND

Speech

Speech by the Governor at the Newcastle upon Tyne Civic Centre

Speech given by

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24 February 1999

Some months ago, by quoting my initial reaction to his leading question totally out of context of my fuller reply, a political journalist gave the impression that I had accepted without qualification his proposition that unemployment in the North East was a price worth paying to curb inflation in the South. Well, I learned a lesson about a particular journalistic technique which perhaps I should have learned before.

It was a disappointing experience - not because it got me into a certain amount of hot water, I'm used to that in my job! It was disappointing, first, because of its unnecessary damaging effect on morale here in the region at what I know is a difficult time, and, of course, I very much regret that. And it was disappointing, too, because it created the impression that we at the Bank of England don't care about unemployment. In fact nothing could be further from the truth. Of course we care, just as you do, about activity and jobs in every sector of the economy and in every part of the country. So, I've come to the North East today to set the record straight.

To be fair, the journalist who gave this impression is not alone in thinking that we are only interested in controlling inflation. That is perhaps understandable: our monetary policy marching orders, set by the Government, define our immediate objective in terms of a precise 2 ½% inflation target; it is that objective that guides the Monetary Policy Committee's decisions about interest rates; and we are publicly accountable for keeping the rate of inflation continuously broadly in line with that target.

But where people go wrong is in thinking that this emphasis on controlling inflation means that we see consistently low inflation simply as an end in itself. We don't, and nor does either the present Government, or its predecessor, which also set an inflation target as the objective of monetary policy. We all in fact see controlling inflation, not as an end in itself, but as a necessary means to the end of sustainable growth of real economic activity, of high levels of employment, and of rising living standards, which of course to anyone in their right mind are the truly good things of economic life, which we are all seeking to achieve. We are not in the business of sacrificing jobs to bring inflation down, we are in the business of keeping inflation down to create jobs and higher living standards for the medium and long term.

Often in the past in this country we behaved as if we thought there was a trade-off between the rate of inflation and the rate of real economic growth. We acted as if, by pumping up demand, we could have a bit more growth if we were prepared to accept just a bit more inflation. In the process we paid too little attention to the structural, supply-side, capacity of the economy to meet the higher demand. And we ended up in effect trying to squeeze a quart out of a pint pot.

You all know the result. Inflation accelerated until it had to be brought back under control and to do that we had to push up interest rates dramatically inevitably plunging the economy into serious recession. We get up-tight these days when interest rates rise by ¼%; but it was only 14 years ago that we were driven to raise interest rates by 4% in the space of 17 days! I don't need to remind you of the really miserable social as well as economic consequences - as in every region of the country people, and it is in the end all about people, lost their jobs, their homes, and their businesses. And more insidiously, repeated experience of boom and bust produced a pervasive short-termism in business behaviour, which infected both industry and finance, and both employers and employees, however much we all like to blame everyone else. The reality during this period was that everyone was tempted to grab as much as they could while the going was good, because they knew it would not last.

But we have learned from that experience. We've learned that, in anything other than the short term, there really is no trade-off between growth and inflation. What we are trying to do now through monetary policy is to keep overall demand in the economy growing continuously broadly in line with the supply-side capacity of the economy - as a whole - to meet that demand. Low inflation is, as I say, not simply an end in itself; it is in effect a barometer of our success in keeping demand in line with supply. So the real aim of monetary policy these days is to achieve stability across the economy as a whole in this much wider sense.

Now, there is not a lot, frankly, that we can do, directly through monetary policy, to affect the supply side of the economy - the underlying rate of growth that can be sustained without causing inflation to rise. That depends ultimately on the ingenuity, the productivity, and the flexibility, of the economy, though it can, of course, be influenced by the whole raft of Government policies, ranging from education and health, through taxation and social security, to the balance between regulation in all its forms, including regulation of the labour market, and productive efficiency. Like the setting of the objective of monetary policy, these are, of course, quite rightly, matters for elected politicians.

Monetary policy operates on the demand side. And the best help that we can give is to keep overall demand consistently in line with supply-side capacity - symmetrically not letting it run above capacity but not letting it fall below capacity either -as reflected in achievement of the inflation target. That way we can moderate rather than aggravate the unavoidable ups and downs of the business cycle, enabling steadier growth, high levels of employment and rising living standards to be sustained into the medium and longer term. And if we can do that, then we will contribute indirectly to the supply side by creating an environment which encourages more rational, longer term, decision-making throughout the economy.

So that, Chairman, is what we are trying to do. It's not a question of whether unemployment is a price worth paying for curbing inflation, as if they were alternative options. High levels of employment and effective price stability are more like love and marriage - you can't have one without the other, at least for very long!

Let me illustrate the point with some relevant facts about our economic performance over the past six years or so since we adopted an inflation target.

Inflation over this period has in fact averaged about 2¾% a year on the target measure and has recently been almost spot on its 2½% target. And that's good news.

But equally important, real economic activity has grown continuously - at an average annual rate of around 3%, which is well above our long-term rate of growth of underlying capacity of some 2-2½%. That's even better news.

But the best news of all is that employment has risen consistently since 1992 to an all-time high of 27.3mn. And the rate of unemployment (on the claimant count measure) has fallen from a peak of 10.5% for the UK as a whole in early 1993 to its present rate of 4.6%, which is the lowest rate for nearly 19 years.

So there is no evidence, in the data for the economy as a whole, to suggest that low inflation has been at the expense of real economic activity and jobs; if anything, by comparison with our earlier experience, it supports the view that greater price stability contributed to growth and employment over the recent period.

And what has been true for the economy as a whole has been true for every region of the economy, including here in the North East. Claimant count unemployment in this region peaked in 1993 at the appalling rate of 13.1%. It has recently fluctuated around 7.3%, which is still unacceptably high even though it is as low as it has been since early 1980. So there's no evidence to suggest that greater price stability has been anything other than beneficial to the regions either.

But, for all that, the going has certainly got much tougher over the past couple of years or so, confronting us with some unusually difficult monetary policy dilemmas.

By around the beginning of 1997 it was becoming clear that overall output growth needed to moderate if we were not soon to run up against capacity constraints.

But there was, of course, a major complication. From around the autumn of 1996 there had been a very sharp appreciation of sterling's exchange rate against the core European currencies. This seemingly had little to do with relative monetary conditions and perhaps more with market perceptions - or rather misperceptions in my view - about the prospective weakness of euro, the new single European currency. But whatever the cause, the effect was to introduce a pronounced imbalance into the British economy. The strong exchange rate threatened to dampen demand for UK exports, particularly exports of manufactures, and it had a direct restraining effect on cost and price inflation, but domestic demand was unsustainably strong and, in terms of aggregate demand, we were approaching full capacity utilisation.

This situation confronted us with an uncomfortable choice. We knew that if we tightened policy to avoid overheating in the economy as a whole, we would be likely to push the exchange rate up even further aggravating the pressures on the internationally-exposed sectors of the economy, and of course on the regions where those sectors were most concentrated, including of course the North East. But we knew, on the other hand, that if we didn't tighten policy at that stage and head off an acceleration of inflation, then that would have put the whole of the economy at risk - including the internationally-exposed sectors (and regions) that we were aiming to shelter. In fact we had no real choice but to tighten - had we failed to do so it would have provided at best short-term relief to the sectors under pressure and would have simply meant tougher policy action a bit further down the track. That was in effect the background to the policy tightening from around the middle of 1997, though in our tactics we did try to minimise the damage. This episode illustrated rather vividly the point that monetary policy can only target the economy as a whole - it can't seek to protect individual firms or sectors, or therefore regions, however much we all might wish it were otherwise. That was the obvious, but very uncomfortable, reality that I was seeking to explain.

By the late summer of last year it looked as though things might be beginning to fall into place. The exchange rate had started to ease against Continental currencies following the decision to go ahead with the introduction of the euro; and there were signs, too, that domestic demand was beginning to moderate.

But we were then hit on the turn by a massive new external shock as evidence accumulated of a sharp slowdown in the world economy following the financial turbulence affecting the flow of capital to emerging markets. The countries suddenly cut off from capital inflows suffered massive depreciations and were forced to cut back, sometimes brutally, on domestic demand in their economies; and this will inevitably have as its counterpart a sharp deterioration in the external position of the industrial countries - including new pressure on the internationally-exposed sectors not just in this country, but, as we are already seeing, throughout the industrial world.

The result in this country was an abrupt decline in industrial - especially manufacturing - confidence; and widespread, and often exaggerated, fears of recession which in turn appeared to undermine consumer confidence. The slowdown - or soft landing - we had been deliberately seeking to engineer rapidly threatened to turn into a much sharper decline then we have either expected or needed to keep inflation on its 2 ½% target track. And that, of course, is why we promptly changed our monetary policy stance - cutting interest rates by 2% to 5 ½% in the space of five months.

In doing so, we have I hope demonstrated that the inflation target is symmetrical, and kept the promise I have given in the past to be just as rigorous and determined in cutting interest rates if we thought we were likely to undershoot the inflation target, as we had been earlier in raising rates to avoid a prospective overshoot. That commitment to symmetry remains.

Taking account of these interest rate cuts in this country, together with the easing of monetary policy elsewhere in the industrial world, the Monetary Policy Committee's view - as I explained elsewhere last week - is that while we will not see much growth in the first half of this year - certainly in the internationally-exposed sectors of the economy - overall output growth will pick up on the back of stronger domestic demand as we move towards the Millennium to around trend or above from the second half of next year. We can't of course altogether rule out an actual downturn in total output over the next few months, though the odds are against that for the economy as a whole. And we are reasonably confident that the slowdown will be relatively mild and short-lived - certainly compared with equivalent periods in the past, for example at the beginning of the 1980's and 1990's. The good news is that we expect inflation to remain close to the Government's 2½% target over the next two years, which should allow the relatively steady growth we have seen in the overall economy since 1992 to resume on a sustainable basis.

Given the starting point of our own economic cycle now overlaid by the slowdown of the world economy, if the overall outturn over the next couple of years is anything close to this we will not be doing badly compared with comparable periods in the past. But within this overall picture the imbalance between domestic and external demand will continue to pose difficulties at the sectoral and regional level.

That will not make our job of implementing overall monetary policy any easier. As I say we can only hope to target the balance between demand and supply in the economy as a whole: it would not make life any easier for anyone except possibly in the very short run, if we allowed overall demand to become excessive - though we certainly do not want unnecessary slack in the economy either.

But of course I understand that it will not make life easier, either, for those sectors of the economy most exposed to international competition or for the regions in which they are most heavily concentrated. There is, frankly, no easy answer to this - I wish that there were.

But it is by no means all gloom here in the North East. When I was last here, some five years ago, I was very impressed by the robust attitude I found everywhere to the need to adapt to the changing external environment. I noted, for example, the way in which production had shifted on the rivers from shipbuilding to platforms to floating production platforms, and I noted the diversification elsewhere into car production and electronics. When I asked about this at lunch - one of the businessmen present replied "yes it's true. There was a time when we tended to look backwards, trying to hold on to what we had. Today in the North East we look forward to new opportunities and what we might have." I see that attitude reflected in the further diversification that has occurred since I was last here - including diversification within the service sectors. And I found the same attitude among the delegation from the region which Jim Cousins brought to see me just before Christmas.

Through that attitude and that willingness to adapt you are doing a very great deal to confront the problems currently posed by the difficult external environment. And the Government is, I believe doing what it can to help, for example, through the TECs and Business Links, and through the additional impetus that will hopefully come from the formation of the North East Development Agency (in April), which should help to bring forward the proposed Regional Investment Fund. The Bank of England in its broader role and through its Agent here in Newcastle will do all that it can to support you.