BANK OF ENGLAND

Speech

Institute of Chartered Accountants Dinner

Speech given by

The Rt Hon Edward George, Governor of the Bank of England

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Madam President, Archdeacon, My Lords, Ladies and Gentlemen,

It's a pleasure to be here and it gives me a welcome, and overdue, opportunity to thank Sheila Masters, publicly, for the great contribution that she makes to the life and work of the Bank and for the huge effort that she puts into that.

It has to be said – after the review proposed last week of your position under the Competition Act – that accountants are not universally popular. But lack of universal popularity is something which, after last week, accountants share with lawyers apparently, and even with bankers – by which of course I mean commercial rather than central bankers!

And yet we couldn't do without you. As the recent global financial turbulence forcibly reminded us, the professional market infrastructure is crucially important to preserving financial stability. I'm strongly in favour of increased competition in every field – it is the engine of innovation and efficiency. The trick in this case is to achieve it without lowering standards or increasing the risks in the financial system.

Most people nowadays accept the generally positive role of private financial markets – nationally and globally, as a powerful driver of economic growth. That's not to say they're infallible – no-one would suggest that – but they are generally seen – even still in the emerging world that suffered so much damage from the recent volatility – as the best means we have of allocating resources to where they can be most productively used.

But financial markets cannot perform that function effectively without a reliable and predictable legal framework, without clearly-drawn lines of responsibility – between and within the public and private sectors, without suitably enforced prudential guidelines governing the behaviour of banks and other investment institutions, or without well-defined and transparent accounting standards consistently applied. Weaknesses in these areas, among others, were starkly exposed by the emerging markets crisis, but they are certainly not confined to those markets. A huge effort is underway internationally, involving both official and private professional bodies, to strengthen the infrastructure in all of these areas. But I welcome particularly this evening the commitment of the accounting profession and its member firms, working through an impossible confusion of acronyms, including of course the ICAEW, and working together with financial supervisors and regulators to raise accounting and auditing standards world-wide and to ensure that they keep up with market developments.

All of this is a necessary condition for the more effective functioning of financial markets. It is not of course a sufficient condition. More robust professional infrastructure, and the greater transparency that flows from it, should contribute to better informed and more reliable market judgements about risk and valuations. But those judgements also involve necessarily more subjective opinions about prospective developments for which you really need a crystal ball. And those opinions are likely to be particularly diverse and volatile in periods of rapid change such as we are experiencing now. Alongside familiar uncertainties, markets everywhere are clearly struggling to evaluate the likely effects of the revolution in information and computing technology on productivity and costs, and on prices and margins and future earnings growth, within and between both "old" and "new" economy sectors and business both here in the UK and abroad. And this produces often erratic price movements, which one bewildered observer recently described to me as more like a sitcom than a dotcom.

Well, if it's any comfort to you, we at the Bank are in much the same boat as we attempt to predict the future course of the macro-economy, and keep it on an even keel through the operation of monetary policy.

We start from a position in which the economy as a whole is performing encouragingly well. Having come through the global economic slowdown of a year or so ago we are now again growing at above trend, employment is at an all-time high and unemployment is lower than it has been for about 20 years, inflationary expectations are lower than they've been for a generation and inflation itself continues to run somewhat below the Government's target, as it has been for the past nine months or so.

Our problem within this overall picture, is a continuing imbalance between the domestically-oriented and the internationally-exposed sectors of the economy. In part the pressures on the internationally-exposed sectors are a hangover from the earlier collapse in demand in many emerging markets, though happily they are now recovering. But the more important factor is the persistent weakness of the euro – not just against sterling but also against the dollar and more recently against the yen. I don't have any very convincing economic explanation of the euro's persistent weakness, certainly since the Eurozone economy began to strengthen from around the middle of last year. Some argue that it is a reflection of market concerns about structural flexibility in some parts of the Eurozone, which encourages direct capital outflows attracted elsewhere by higher prospective earnings growth. But, whatever the cause, very few of the analysts I talk to expect the weakness of the euro to persist.

But in the meantime there is no doubt that, even if euro weakness is not at the root of their problems, it is adding to the pressures bearing down on large parts of the UK economy – including much of agriculture, important sectors of manufacturing and some services sectors.

Sadly, however sensitive we may be to these sectoral, and associated regional, problems, there is not much that we can do directly about it. In itself the weakness of the euro has a dampening effect upon our own price level. And it reduces external demand in the UK economy. We can – and indeed do – seek to offset these effects through higher domestic demand growth encouraged by interest rates that are lower than would otherwise be necessary to keep inflation on track. But the much more difficult question is could we – and should we – go further and endeavour to weaken the exchange rate, in order to provide more shelter to the internationally-exposed sectors, by cutting interest rates, even if that meant putting the whole of the economy at the risk of accelerating inflation. Few people argue explicitly for that. If we were to do so, we would almost certainly damage the prospect of continuing growth in the economy as a whole and provide no more than short-term relief to those sectors we were seeking to help.

Even as it is the danger in our present situation is that we could find it difficult to moderate domestic demand growth to a more sustainable rate if and when the euro does strengthen. But that is for the future. The fact that inflation starts below the target, and is expected – as a result partly of smaller indirect tax increases in this year's Budget and partly of price reductions imposed by utilities regulators – to remain there for the time being, gives us some protection against that situation.

In trying to discern the way ahead we are currently handicapped by millennium fog which makes it particularly difficult to assess the degree of pressure in the labour market – with wage settlements and earnings growth apparently giving different messages.

And the position is unusually complicated by what I might loosely call the "new economy" uncertainties. It is possible that we might over the next couple of years – which is the extent of our forecasting horizon – see the sort of acceleration in underlying productivity growth that we have so enviously observed in the United States. The trouble is that we cannot so far see that in our own data. It is also possible that intensified competition, driven by the greater transparency of e-commerce (at either the business to business or business to consumer level) might cause a widespread compression of profit margins. In both cases retail price inflation could for a time be lower than we would otherwise expect given the demand pressures in the economy – though even if that happened we would not know for how long this would last, nor what the size of the effect might be. Such benign effects are certainly possible. If they materialised they would allow us to hold interest rates lower for longer than otherwise – consistently with achievement of the inflation target. But they are not guaranteed. If we made undue allowance for such influences in our projections (and we do in fact make some allowance for them in terms of our collective assumptions), and if they did not materialise to that degree, then inflation would tend to overshoot the target, and again we may then find we needed to act more vigorously to bring it back on track.

So, despite the present, reasonably encouraging, overall macro-economic data we are confronted with some uncomfortable dilemmas – dilemmas relating to the domestic/external imbalance within the economy and to what always seem to be unusual uncertainties relating to future developments. I am conscious that this may sound like a litany of doubt which I suppose in a way it is. Indeed it may bring to mind a recent dotcom prospectus, which after careful exposition of the company's (relatively short) history and description of its business plans, together with details of its profit, or rather loss, account to date, then goes on for some ten pages explaining, in unequivocal terms, the risk factors surrounding the issue – including such statements as "we are not profitable and expect to continue to incur losses" and a long list of possible reasons why the share price might decline! The issue went to an immediate premium!

Just like investors contemplating subscription to the issue, we on the MPC are very much in the business of assessing and trying to balance risks. And it can be an agonising process. The key thing – generally but especially in our present situation – is that we should keep an open mind, and scrutinise the continuous stream of data, as it becomes available month by month or quarter by quarter, like a hawk – or if you prefer like a dove – or even an owl – for signs that we may be going off course in one direction or the other.

But for all the uncertainty – and the differences of judgement within the MPC to which that quite naturally gives rise – the broad prospect, as we currently see it, for the economy as a whole over the next couple of years remains positive. It is for continuing relatively strong growth, with a continuing relatively high level of employment, and continuing relatively low inflation. The policy debate for the time being is in fact a comparatively narrow one about just how strong the growth, how high the level of employment and how low the rate of inflation. And that, Madam President, is perhaps an encouraging note on which I might conclude.