BANK OF ENGLAND

Speech

New Economy – Same Old Problems!

Speech given by

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New Economy - Same Old Problems

Thank you, Mr President. I'm honoured to have been invited back to address your annual conference.

I remember very vividly my earlier visit to your conference in 1996.

I remember reporting to you that the British economy was then into its fifth consecutive year - its nineteenth consecutive quarter - of relatively steady growth at an annual average rate of 2.6%; that unemployment had fallen, pretty well month by month for most of that time, to below 7½%; and that inflation had averaged 2¾% over the previous four years - compared with over 10% on average in the preceding two decades.

The question then was could we keep up - or even improve upon - that performance. And my answer was a cautious yes - provided we met three conditions: a continuing firm grip on inflation; continuing prudent and sustainable fiscal policy; and continuing structural, supply-side, flexibility.

Well, that cautious optimism was amply justified. Today, we are well into our ninth consecutive year - our thirty-third consecutive quarter of relatively steady growth (despite having to absorb the global emerging markets financial shock of a couple of years ago) at an annual average rate of 2.8%; the number of people in employment has risen to an all-time high; the rate of unemployment, on a claimant count basis, has fallen to 3.6%, which is the lowest rate for 25 years for the UK as a whole and the lowest rate for 20 years in every individual region of the UK; and retail price inflation on the target RPIX measure has now averaged 2.7% over the past 8 years, and on the standardised HICP measure is currently the lowest rate in Europe.

And if you ask me today the same question - can we keep up that performance, my answer is still a cautious yes - on the same three conditions - low and stable inflation, fiscal prudence and supply-side flexibility.

Now I am very well aware that some of you - perhaps many of you - thinking of your own businesses - may conclude that I'm living on a different planet.

Beneath the surface of these encouraging macro-economic data, there is - and has been for some time - a serious imbalance, with some parts of the economy doing very well (including many of the services sectors and some manufacturing activity) while other parts of the economy (including much of agriculture, many manufacturing businesses and even other services sectors such as inward tourism) face the toughest business conditions that many of them can remember.

To take just manufacturing, total output has risen by only 2% over the past two years, and it has actually fallen by 0.9% if you exclude the so-called "high tech" sectors (ie computers, office and telecommunications equipment and electronic components).

Total employment in manufacturing has fallen over that period by some 230 thousand, of which 200 thousand were outside the "high tech" sectors. For what it's worth there is a similar imbalance in the US, where total manufacturing has increased by 10 ½% over the past two years, but by only about 1 ½% similarly excluding the hi-tech sectors; total employment in US manufacturing has fallen by some 435 thousand, but by nearly 600 thousand, outside the "high tech" sectors.

There is no single explanation for these developments. They result partly from continuing and unavoidable long-term structural adjustment of capacity to market demand; it results also partly from the effect of increasing global economic integration, inducing the relocation of manufacturing capacity in response to shifts in comparative productive advantage. But there is no doubt that some of these effects have been aggravated by exaggerated changes in foreign exchange rates - including the progressive weakening of the euro. That is a particular problem for the UK because of the relatively large proportion of our economy exposed to competition from the Eurozone (both in terms of our bilateral trade and competition in third countries). Even as a central banker I can understand why many euro-exposed businesses feel hard done by in present circumstances. And I can understand why they in particular might urge the Monetary Policy Committee to signal that UK short-term interest rates have peaked.

They make a seductive case. But in fact it's not as straightforward as it sounds.

If the intention is that by signalling that our interest rates have peaked we might weaken sterling against the euro, it is not at all obvious that it would in fact have that effect. Today's exchange markets between the major currencies are apparently being driven primarily by massive longer-term capital flows - direct and portfolio investments - which, for the time being, are overriding more conventional "fundamentals". Those longer-term capital flows in turn appear to be driven more by investors' perceptions of structural, supply-side, differences, and their implications for relative future corporate

earnings growth, than by relative macro-economic policies. No doubt at some point such perceptions will change - or the anticipated differences in future earnings growth be discounted by the change in asset prices, including the effect of exchange rates. There are some tentative signs that this may be beginning to happen. But in the meantime it is not at all clear that there is much that we could do - even if we wanted to - to weaken sterling against the euro by marginal changes in short-term interest rates. As it is our interest rate differential over the Eurozone has halved since the euro started, while our exchange rate against the euro has appreciated by around 15%.

We do already, of course, take full account of the exchange rate - and other prices - in both our forecasts and our policy decisions. Indeed, it was partly to avoid pushing sterling higher and so aggravating the imbalance within the economy, when we were not wholly convinced that we needed to take that risk in order to achieve the inflation target, that the Committee refrained from further monetary tightening over the past eight months.

But looking ahead the risks and uncertainties are such that it would be unrealistic to suppose that we can altogether exclude the need for further tightening at some point.

Leaving on one side possible, though not necessarily likely, international developments outside our control - a hard landing in the US, for example, or a precipitate realignment of exchange rates, or a further spike in the oil price - there are two major uncertainties.

The first is the familiar uncertainty relating to the path of overall demand growth. On almost any basis, we start from a position in which the economy as a whole is operating close to capacity. That is reflected in the evident tightness of the labour market, including increasing evidence of skills shortages. If we are to avoid a potentially sharp reversal in earnings growth and accelerating inflation, we need to see a slowdown in the rate of domestic private sector demand growth to accommodate not only the stabilisation of our external current account balance but also the public sector expenditure growth which the Chancellor has already announced, not to mention whatever he may be planning to announce tomorrow. There are signs that this slowdown in private sector demand growth may be beginning to happen, but that is certainly not yet assured - and over-generous tax cuts would not help. I must tell you that I am surprised by the billions of pounds that some commentators have suggested the Chancellor could safely give away tomorrow.

Going in the opposite direction, we have recently seen a more benign relationship than we might have expected between developments in the real economy and earnings and price pressures - the nominal side of the economy. In part the explanation for this encouraging development may lie in the dampening effect of the strong exchange rate or in the lower and more stable inflationary expectations we are now seeing. But other possible explanations include exceptional competitive pressure in goods markets, structural changes in labour market behaviour or an underlying improvement in productivity growth, or in some combination of all three. Whatever the underlying cause, it is possible that, at least for a time, we can sustain a higher rate of growth of overall demand and output without inflationary pressure than we could in the past. The jury frankly is still very much out on all of this. The difficulty is that most of these possible developments cannot be directly observed in the data, and, even if they could be, we would still not know whether or not, or for how long, they might persist.

We certainly have not closed our mind to a continuation of such benign "new economy" effects, indeed we make conscious allowance for them as best we can in our projections. But we cannot bank on them. All we can - and do - do is, continuously and meticulously, to monitor the evolving evidence. We watch it, in fact, like a dove.

What that means is that while we can't realistically rule out further interest rate increases, we don't rule out the possibility that the next move will be downwards either.

In the final analysis, Mr President, we have a choice. We could, in principle, go further than we have, and deliberately aim off in our monetary policy, in order to try to relieve the immediate pressure on the euro-exposed sectors. But that would necessarily involve taking more risk with our inflation target and with continuing stability in the economy as a whole. That is not consistent with our mandate. And it is not something that most business people I speak to - even from the suffering sectors - would want us to do.