



BANK OF ENGLAND

# Speech

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## **Scottish Engineering Senior Executive Dinner**

Speech given by

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As you know, the Monetary Policy Committee has a single target – to keep RPIX inflation at 2½% per year. In order to do this, because the overall national economy is the sum of its many parts, we closely monitor the diverse regional and sectoral developments to get a clear view of the whole. Indeed this monitoring is an explicit part of the Chancellor's remit to the Committee. An evening with Scottish engineers surely helps to fulfil this, and so I am doubly pleased to be with you tonight.

The MPC has just completed its regular quarterly assessment of the state of the economy culminating in the publication of the Inflation Report and its forecast for the next two years. I am happy to report that the UK economy is in good shape. The economy grew by 3.1% in the year to June and is currently enjoying the longest continuous expansion in quarterly output since 1955. The unemployment rate (LFS) has halved since the mid-1980s, and fell further to 5.5% in June. Employment is at a record level. Scotland has shared in this buoyancy. Its unemployment rate has also halved since the mid-1980s to 7.2%. Though it is still higher than for the UK as a whole, the differential has narrowed markedly.

This impressive national performance has taken place in a climate of benign pay pressures and declining inflation. RPIX inflation was 2.2% in July - the 16th month in which it has been below the target. This undershoot has been one of the reasons we have not changed interest rates for the past 6 months, given the symmetry of the government's inflation target. Taking a slightly longer timeframe, since the MPC was set up in May 1997 RPIX inflation has ranged between 2% and 3% with the exception of just two months. There is a good prospect that over the next two years we will have more of the same – steady growth with low inflation.

Beneath these calm waters, however, there are some cyclical undercurrents. We think that private spending growth may be slowing from high levels, partly in response to the four interest rate rises between last September and this February and the strength of sterling. But the view is muddled by erratic growth outturns reflecting Millennium distortions. As these unwind, we will have a better idea of whether private demand will slow sufficiently to create room for the planned increases in government spending over the next few years. The Committee also remains vigilant to any resurgence in pay pressures stemming from a tight labour market and persistent skill shortages – though the latest earning numbers offer some encouragement on this front.

Understanding the cyclical state of the economy is necessarily a short term – and at times hazardous – occupation, concerned with assessing the 'news' about inflationary pressure in each piece of economic data as it becomes available. But it is also important to take account of the less readily observable structural influences that affect our economy, which is what I want to turn to now.

Though structural changes are generally slow-moving, their cumulative effect can be large especially during periods of accelerated technical progress. In the 1920s for instance, the US and UK economies experienced accelerated growth (interrupted by the War) as electricity replaced mechanical drive in industrial production. Now in the 1990s a number of simultaneous innovations – the development and spread of information and communications technologies (ICT), the rapid expansion in world trade and foreign direct investment, and the launch of the single currency in Europe – create the prospect for our economies to embark upon another wave of productivity-led growth.

This already appears to be happening in the US. Since 1995 US productivity growth has accelerated by around one percentage point per year. It has outpaced productivity growth in the UK, reversing the tendency for UK productivity to grow faster as part of the catch-up process to higher US levels. The acceleration in US productivity growth is particularly noteworthy because it has occurred late into its economic cycle, when it is more usual for productivity growth to slow. A convincing case can be made that developments in the US are a leading indicator of events here. The UK, like the US, has seen a sharp increase in investment spending on ICT in the latter part of the 1990s, and productivity growth has recently begun to rise.

Within the manufacturing sector there are dynamic new growth areas. High-tech industrial sectors, such as computers and mobile phone production, have achieved double-digit growth in three of the past four years, in contrast to declining or static output in the manufacturing sector as a whole. Indeed B2B commerce and the tremendous scope it offers for cost reductions through global procurement and greater outsourcing cuts across sectoral boundaries. This is changing the shape of the corporate landscape – from the auto to the airline industry, from 'old economy' retailers to 'new economy' e-banks.

Rather than simply exacerbating the old dichotomy of manufacturing versus services, these changes are creating intense pressures for root and branch restructuring of companies of all types, and up-skilling of their employees. This is creating an interesting economic dynamic - in the growing dispersion of both profits and wages.

Two analysts at the Bank of England have recently carried out an interesting study on the distribution of profitability across publicly listed UK companies and how this has changed over time.<sup>(1)</sup> The results are striking. The researchers find that if companies are ranked according to their return on capital or operating margins, the difference between profitability at the 90th and 10th percentile has increased sharply since 1995. At the bottom of the distribution, profits

have collapsed. One possible explanation of the widening distribution of profits is that greater competitive pressures are raising price transparency, eroding margins, and shortening the time available for companies to react.

Firms are acutely aware of the likely impact of greater diffusion of ICT. In a survey on e-commerce conducted by the Bank's Regional Agents in June, nearly 90% of firms said that they already had a website and 100% expected to have one in 2 years time. For many firms, this was being used as a marketing tool rather than to make purchases and sales, but this was expected to change rapidly over the next couple of years with component sourcing growing especially fast.

Mirroring trends in profitability there is a shift towards greater dispersion in wages, though this has been going on for longer. The Dutch economist, Jan Pen, once illustrated this by imagining a parade in which the height of the participants corresponds to their earnings. In the UK, the person in the middle is about 5ft 9 inches. The poorest workers are only 3 feet tall while chief executives are over 300ft – and the David Beckham's of the world would have their heads in the clouds!

There is a long running academic debate on whether the widening in the wage distribution is caused by globalisation or shifts in technology. I believe that these two forces are not mutually exclusive – increased global competition spurs the adoption of productivity-enhancing technology, just as the new technologies shrink our world.

Salaries have been bid up at the top of the wage distribution, as mergers and acquisitions raise the scale of decision-making and raise the performance stakes for top management. Across the workforce as a whole, pay norms and expectations are changing as compensation is restructured to reflect productivity differences and performance.

A widening wage distribution can be good for the economy as long as it is accompanied by sufficient wage mobility, so that people do not become stuck in low-paid jobs. Indeed, countries which attempt to compress their distributions in the face of structural change may end up with the worst of both worlds, with higher unemployment at the bottom of the distribution (which increases inequality) and skill shortages at the top.

Bringing all of this closer to home, what do these structural changes mean for Scotland's place in the national and global economy? The latest regional forecast by Cambridge Econometrics predicts that the Scottish economy will expand by 1.75% this year and 2.5% next year. Though these rates are lower than in the UK as a whole, the manufacturing sector in Scotland is expected to outperform that of the UK, driven by robust growth in the electronics, electrical and instrument engineering sectors.

Scotland's strength in high-tech sectors make it well-positioned to benefit from the structural changes afoot. It has one of the largest concentrations of semiconductor manufacturing companies in Europe, accounting for half of Britain's total semiconductor output and 15% of Europe's chip production. It has the highest share of manufacturing investment from foreign-owned companies out of all UK regions, attracted by its skilled workforce and proximity to European markets, and the highest ratio of exports per employee.

But there are major challenges ahead. Exchange rate volatility is likely to stay with us, and there are few signs that the strength of sterling is about to be significantly reversed. On the structural front, downward pressures on prices are likely to persist, as emerging economies continue to gear up their productive capacity and skill base, enabling them to move up the value-added chain. ICT will bring them directly into our markets, as we have long been in theirs. Labour market trends - namely the ageing of the workforce and the shift towards women – pose new challenges for companies in managing and motivating their vital human capital.

These structural changes which I have described make my job both more difficult and more interesting. Shifting trends limit the extent to which the past provides a useful guide to the future. This makes it harder to judge the state of inflationary pressures in the economy by looking only at demand indicators.

It also makes your job more challenging as the pace of change – which is the fastest I have seen in 25 years as an applied economist - accelerates. But to the extent that we on the Monetary Policy Committee are successful in delivering a more stable macroeconomic environment, then that, at least, should free you to focus on creating the productivity growth and competitive strategies that form the basis of our future prosperity.

(1) "Stylised facts on UK corporate financial health: evidence from micro-data" by Andrew Benito and Gertjan Vlieghe. Financial Stability Review, June 2000.