



BANK OF ENGLAND

Speech

Speech given by

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I'd like to start with a few words - but only a few - about the current state of the British economy, and then move swiftly on to the much more worrisome state of the US economy and on how developments there may affect us. This is what I consider the main economic question of the day for British business and, indeed, for the Monetary Policy Committee on which I serve.

First, the situation here. Britain today is enjoying its ninth year of uninterrupted economic growth. This growth is widely shared across all regions of the UK. Of course, the immediate problems in those rural areas affected by the foot and mouth outbreak provoke concern and sympathy from us all. But the latest data show the economy as a whole growing at 2.5% per year, which is close to many estimates of its long-term sustainable rate. Unemployment is lower than it has been for at least 20 years, the pound is still strong but has come off the uncomfortable peaks it had scaled against the euro last Spring. Inflation is low and stable - in fact a bit too low at around 2%, compared to the Bank's target of 2.5%.

To sum it up, if I were speaking to a business audience in America, I'd say we were doing fantastically well. But having lived in this country for more than 15 years now, and having become a cautious central banker over the past 4, I guess I should say "so far, so good."

Unfortunately, I can't say the same for the US. Six months ago we were hoping for a gentle slowdown, a so-called soft landing, after four years of heady growth, led by an investment boom that drew upon, and fed into, the huge rise in stock market valuations. That bubble has now burst. The landing has been a hard one.

How did it happen? The investment boom caused excess capacity in a number of sectors and profit warnings proliferated. That caused the Nasdaq, with its heavy concentration of hi-tech stocks, to lose over 60% of its value since last March. The broadest index of US share prices, the Wilshire, is now 30% off its peak. The combination of excess capacity and the sharp rise in the cost of capital dramatically curtailed investment spending. On the consumer side, with over half of US households holding shares directly, it led to a steep fall in consumer confidence.

The question now is whether the aggressive easing of monetary policy by the Fed will quickly stem the decline in confidence and stimulate a V-shaped recovery in the second half of the year. My own view is that this is looking increasingly unlikely. The large imbalances that developed over the past 4 years, will take time to unwind. Thus, at this point, I think it is more likely than not that the US economy will suffer at least a shallow recession and a protracted recovery, rather than a quick bounce-back.

That brings us to the final question: how would such a US recession affect the UK? I would like to tackle this on 3 levels: cyclical links, medium-term fundamentals, and the scope for policy response.

Cyclical links between the UK and the US economies are strong, not just through trade flows but also through financial markets and foreign direct investment (FDI). The correlation between the Wilshire index and the FTSE All-share over the 1990s is high at 97%. The US and the UK are the world's two largest international investors, and their investments in each other are the largest for each of them. Fully one-fifth of the stock of inward FDI in the US comes from the UK. Around two-fifths of the stock of inward FDI in the UK comes from the US.

Despite these close links, it is important to recognise that the medium-term fundamentals are quite different in the US and the UK. The late 1990s boom in share prices was not as marked in the UK; households are not as exposed to the stock market here; savings have not turned negative; the current account deficit is not as large; and we are less vulnerable to a rise in oil prices. These differences mean that it is unlikely that the UK economy would mimic the pattern of the US downturn, despite the cyclical links between the two. We will be affected, but because we did not experience their boom, we are unlikely to suffer the full brunt of their bust. This is where the symmetry of our inflation target is important. The MPC is charged by the Chancellor to keep inflation stable at 2.5% - no more, no less. This means that if a slowdown in world growth begins to drag our own performance below its potential, so that prospective inflation looks likely to be below target, we are duty-bound to lower interest rates in order to support domestic growth and fill the gap in total demand. And while we can't directly measure potential growth, we can keep an eagle eye on inflation, the key indicator of the supply/demand balance in the economy.

This is not quite as easy as it sounds, because the measured inflation rate is sometimes buffeted by erratic movements in the prices of some items, such as oil, that can obscure its underlying direction. For this reason, I recently commissioned some research by Bank staff to compare different ways of measuring core inflation in the UK and to develop a new measure to overcome some of the short-comings of existing measures. That work, by Joanne Cutler, was published yesterday on the Bank's website. The new measure that she has developed, a persistence-weighted RPIX which we call RPIXP, is a good predictor of inflation 6 to 12 months ahead. Currently it suggests that underlying inflation is just 1.2% and that RPIX will remain below its target level of 2.5% at least through the rest of this year.

This is important in the current conjuncture. In both the US and the UK, policy-makers have made it clear that they are ready to respond to a slowdown in growth. Indeed, both have done so already. But the pace of their actions will depend

very much on their own domestic developments. In the US, the ability of monetary and fiscal policy to restore confidence and quickly reverse the capacity overhang is an open question, given the nature of their downturn. In the UK, with sound fundamentals, still healthy growth and inflation below target, there is ample scope for policy to respond to weaker conditions, and more certainty that such a response would be effective.

In other words, at the moment, I would rather be in my shoes than Alan Greenspan's.