BANK OF ENGLAND

Speech

Mansion House Speech

Speech given by
The Rt Hon Sir Edward George, Governor of the Bank of England

At the Lord Mayor's Dinner for Bankers and Merchants of the City of London
20 June 2001

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My Lord Mayor, Mr Chancellor, my Lords, Aldermen, Mr Recorder, Sheriffs, Ladies and Gentlemen.

It is always a privilege, my Lord Mayor, and a pleasure, to be invited to enjoy the splendour, and the generous hospitality, of the Mansion House on the occasion of this annual dinner for the Merchants and Bankers of the City of London. You provide us with an opportunity - in an atmosphere of calm - to reflect upon the events of the year that has gone by and upon the challenges to come.

And the past year certainly has been eventful - though it is notable that some of those events did not result in particularly dramatic change.

I think particularly of the Election and I congratulate the Government on the outcome, and you, Chancellor, on your own re-appointment. I very much look forward to continuing to work with you.

But I think, too, of our relatively stable overall economic performance - despite the devastating effect on many farmers, and on rural communities more generally, of foot and mouth disease; despite the weather and the floods; despite the disruption on the railways; and despite, above all, the pressures on the internationally-exposed sectors of our economy as a result of developments abroad.

In this last context, my Lord Mayor, I was struck by a recent newspaper comment to the effect that if we were living on an island we'd be in reasonably good shape. Now I have to confess that I'd always been under the impression that we were living on an island, but I let that pass. What I think the writer was drawing attention to is the fact that despite the recent global economic slowdown - notably in the United States, despite the continuing weakness of the euro, and despite the sharp rise in crude oil prices over the past year, we have in fact, in terms of our own overall economy, enjoyed another year of steady progress.

GDP growth in the year to the first quarter - at 2.6% - remained above our longer term trend rate, and was above the rate of inflation, whether measured by the GDP deflator or our target measure of retail price inflation (RPIX), for the sixth time in the past eight years. Since the economic expansion began in 1992, annual output growth has averaged just less than 3% while the rate of inflation has averaged just under 2 ½%. The number of people in employment last year(on the LFS measure) continued to rise fairly steadily to an all-time high; the number of unemployed people fell to below one million (on the claimant count measure) for the first time since December 1975, and the rate of unemployment fell to its lowest in more than 25 years in the United Kingdom as a whole, and to its lowest for more than 20 years in every individual region.

But, my Lord Mayor, even if - as I at least continue to believe - we are living on an island, that does not make us immune from developments abroad.

In particular, we are bound to be affected by current developments in the United States, both directly, and indirectly, through the knock-on effects on third countries, with those effects on the Eurozone particularly important for us.

By this time last year it had become clear that, even on the most optimistic view of improving underlying productivity - as the application of new information and communications technologies spread through the American economy - the rate of growth in the U.S., of over 5%, was unsustainable in the light of increasing domestic and external imbalances. The pace of U.S. domestic demand growth needed to slow - as of course it has.

The big questions now are about the extent of the slowdown and how long it will last.

On an optimistic view we may be largely through the sharp downward stock adjustment, and with consumption so far holding up better than generally expected, and with the possibility that investment will recover as the spread of ICT through the economy resumes, U.S. activity may pick up as we move, say, into next year. But the pessimist can point to the weakness of private sector saving, which could induce more cautious consumer behaviour; he can point to a possible overhang of past investment excesses; and he can point to the U.S. external deficit which will need to be corrected at some point. These adjustments might take place gradually over time, implying a more protracted period of relatively slow growth in the U.S. Or, if you are really pessimistic, you might anticipate more abrupt adjustment, implying a period of negative U.S. growth and global financial instability.

The recent somewhat erratic recovery of U.S. financial markets from their earlier gloom suggests that they may have begun to side somewhat tentatively with the optimists; but some of the survey evidence of consumer and business confidence, on the other hand, supports a more pessimistic view.

The truth is that none of us knows with any great confidence just how the U.S. situation will evolve. For what it is worth I remain modestly optimistic, but I am very conscious of the downside risks. The outcome is obviously the major uncertainty affecting us all.

The other major external influence on the economic situation in this country is the development of the exchange rate. Depending on who you speak to sterling is variously described as dangerously weak, at a 15-year low, against the dollar, or as unsustainably strong, close to its peak, against the euro. The truth is that sterling's effective exchange rate has been relatively stable for most of the past 2 ½ years - at about 105 on the standard index, plus or minus 5%. The bilateral rates that are frequently quoted in fact tell us very little about sterling: they are essentially a reflection of the persistent general strength of the dollar on the one hand and the persistent general weakness of the euro on the other, resulting from sustained capital inflows to the United States in large part from the Eurozone.

It was widely expected that, with the slowdown in the U.S. economy, and associated weakening of U.S. earnings expectations and stock prices, these capital flows would moderate, causing the dollar to weaken and a corresponding recovery in the euro. That clearly has not, yet, occurred, although - given the size of the U.S. external imbalance - it is difficult to see how an exchange rate adjustment can ultimately be avoided.

In the meantime, the stronger dollar - and higher oil prices - have added to inflationary pressures elsewhere. But in our own case this effect has been offset by the weakness of the euro - or by sterling's bilateral strength against the euro, if you prefer - which has dampened both external demand and our domestic price level.

The result of these external developments - the global economic slowdown and the pattern of exchange rates taken together - for us has been that, notwithstanding only a rather modest slowdown of our overall economy, we have continued to see a growing imbalance between the internationally-exposed (particularly the euro-exposed) sectors, which have been having a rather torrid time, and the more heavily domestically-oriented sectors, which have been doing rather better. The weakness of manufacturing alongside continuing growth in the services sectors is a crude reflection of this imbalance.

With inflation running somewhat below the Chancellor's symmetrical 2½% target, and with developing uncertainties about the continuing strength of domestic demand, the MPC was in a position to respond to these developments by reducing interest rates earlier this year.

In fact we cut rates by ¾%, while the Federal Reserve cut much more aggressively, by 2½% over much the same period, and the European Central Bank by just ¼% - reflecting the different overall monetary conditions as they saw them in their respective currency areas. You might suppose that these relative interest rate movements would have encouraged the dollar to weaken against sterling and by more against the euro - and given the pattern of international imbalances it would have been helpful if they had. But, in the event exchange rates moved in the wrong direction, illustrating the unpredictable - even perverse - relationship between relative interest rate and exchange rate movements at least in the short term. That ought to be a salutary lesson to those who imply that monetary policy can be directed to controlling both inflation and the exchange rate at the same time!

So there is not much that we can do directly, through monetary policy, to affect the various external influences weighing upon our economy. But we can attempt to offset their effects, by encouraging the growth of private sector domestic demand to try to keep overall demand in the economy growing in line with potential supply. And that in effect is what we have done through our recent interest rate cuts.

This approach is not, however, without risks. It involves accepting - at least while the dampening external influences persist - a growing imbalance between the internationally-exposed and the domestically-oriented sectors. If we did not accept that, then overall demand and output would be lower, and inflation would tend to fall further below target. But the imbalance cannot continue to grow indefinitely. At some point the elastic is likely to break - quite possibly through a sharp exchange rate adjustment. And at that point, having deliberately stimulated domestic demand growth, we would need to rein it back. But we could then find its momentum hard to stop.

I am not suggesting that we are necessarily approaching that point. Domestic inflationary pressures, including wage pressures, have so far remained reasonably subdued and it is crucially important that that should continue. But it does explain our caution in moving interest rates down.

Somewhat similar concerns explain my reaction to recent speculation that the Government would now make a strong push for early entry to the euro. I take no position on the five economic tests which are a matter for the Chancellor. But I do see the present external environment - and in particular, as I said elsewhere last week, the euro's present weakness - as a potentially serious obstacle to early entry. So I very much welcome the considered and cautious approach to making the assessment of the five tests, which the Chancellor set out this evening.

Most people agree that sterling's exchange rate on entry to the euro would need to be substantially lower than our present rate, which few would regard as sustainable in the medium and longer term.

Given the euro's present general weakness, that could come about in either of two ways.

If, achieving what was considered to be an appropriate entry rate against the euro - whatever that was precisely - involved a substantial depreciation of sterling's overall, effective, exchange rate (that's to say sterling's rate against other currencies generally), that would be bound to put strong upward pressure on our domestic rate of inflation. That would not only destabilise our domestic economy, it would also cause the intended euro-entry rate to appreciate in real terms, with adverse implications for our competitiveness within the Eurozone. These effects would clearly be difficult to contain given the constraints on both our interest rate and the exchange rate as we moved towards entry, and very difficult to reverse once we were inside the single currency area.

This obstacle would diminish to the extent that the euro itself recovers against other currencies generally - as at some point it surely must. In that case sterling might weaken bilaterally against the euro, but it might be expected to strengthen against the dollar and other currencies, leaving our overall, effective, exchange rate closer to where it currently is. That would have less impact on our domestic rate of inflation.

There's no question, my Lord Mayor, that what we would like to see, both in the context of our current monetary management and if we are to join the euro, is a combination of a pick-up in the global economy and a recovery in the euro exchange rate. That would be in all our interests. But it is not at all clear what we can do to bring it about.

In the meantime, as we sail out from our island haven, through conflicting offshore currents and variable onshore winds, we may not find it easy to remain on the course set for us by Gordon the Navigator. We risk either being blown onto the Scylla of excessive domestic exuberance or sucked down by the Charybdis of external weakness. But we remain on watch, ready to tack as conditions change.

My Lord Mayor, yours is a great office with a great tradition. You - and the Lady Mayoress - have maintained that tradition this evening by entertaining us in such splendid style. And you have maintained that tradition, too, in your tireless promotion of the City of London - in its civic affairs, in its business activity, and in its engagement with our surrounding communities. In this last connection I look forward to joining with you and Howard Davies next Wednesday at the Heart of the City Carnival to celebrate, and encourage, the City's community and charitable involvement; and I hope that some of your guests this evening might care to join us at the Guildhall for that occasion.

But in the meantime I thank you for your gracious hospitality and I would ask all your guests to rise and to join me in a toast to your good health.

My Lords, Ladies and Gentlemen, the Toast is

"The Lord Mayor and the Lady Mayoress, David and Val Howard".