BANK OF ENGLAND

Speech

Welsh Development Agency/Bank of England Dinner

Speech given by

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Thank you, David for that kind introduction. And thank you, too, for agreeing to co-host this dinner in the Brangwyn Hall this evening. It gives me great pleasure to add my welcome - on behalf of the Court of the Bank of England - to all of our guests. We are grateful to you for joining us.

I should like to say a few words this evening about the state of the economy, and in particular to account to you - as stakeholders - for the Bank's conduct of monetary policy.

If you look back, since the recession of the early 1990s the UK has enjoyed 9 years of steady progress.

Inflation over that period, on the Government's target measure, has averaged just 2.6% - and has been more stable than at any time in our history. Now some people think that's all we care about at the Bank of England - and we certainly do care about it - it is after all what we are paid for. But it is certainly not all we care about. Low inflation is not simply an end in itself - it is a necessary means to the end of sustainable growth, to sustained high levels of employment, and to rising living standards which are, of course, the really good things of economic life.

And what gives me personally - and my colleagues - real satisfaction is the fact that stable, low inflation has over this period been accompanied by steadily increasing overall output and employment, and by a progressive fall in unemployment.

GDP growth since the Spring of 1992 until this summer has averaged just about 3% a year - which is well above most estimates of our trend rate of 2¼%-2½% - and the longest period of sustained quarter-by-quarter growth we have enjoyed since quarterly records began in the UK in 1955.

Employment increased steadily from a low point of 25 ½ mn people in the Spring of 1992 to a peak of over 28mn in the summer of this year. And the rate of unemployment has fallen from a peak of over 10½% on the LFS measure to around 5%; while on the Claimant Count measure it has fallen from some 10% to just over 3%, which means that the number of people claiming unemployment benefit, at under 950,000, is the lowest for 26 years.

And what has been a good period for the UK economy as a whole, has also been good - in an absolute sense - for Wales. Here on an LFS basis the rate of unemployment fell from the recent peak of over 10½% in November 1993 to below 6% in July this year for the first time since these data were collected; and, on the Claimant Count basis, unemployment, which touched 10% in the winter of 1992-93, had fallen to 3.8% in August, the lowest rate since June 1975.

But I freely acknowledge that it doesn't necessarily feel like that today - certainly not to everyone. I am only too well aware that there are a lot of people in every part of the UK - both business people who've been under real pressure and employees who have lost their jobs - who will react to these statistics by saying "Well you could have fooled me!" That may well be true of some of you here this evening. The Bank receives detailed reports every month from each of our 12 agencies throughout the UK, including reports from Sue Camper based in Cardiff.

Many of you will know Sue already - and I encourage those who don't to make yourselves known to her. The reports which she and her fellow agents make each month, based on their direct, first hand, knowledge of what's happening in their area, are fed directly into our Monetary Policy Committee process. They play a vital part in informing our understanding of the macro-economic statistics which in themselves can only capture the overall, aggregate, picture. So we do know, I promise you, about the job losses and plant closures particularly in manufacturing.

Those on the receiving end won't thank me for saying this but some of those problems at the micro-economic level are an inevitable characteristic of every economy. Needs, tastes, technologies and productive techniques are constantly changing even in the most benign macro-economic environment, and the rise and fall of individual businesses or business sectors, as comparative advantage shifts - nationally and internationally - is a painful but necessary facet of economic progress. Obstructing such change cannot help in anything but the short term. The more constructive approach is to encourage the redeployment of resources to alternative activities where there is a prospect of comparative advantage. Happily that is the path - the path to greater supply-side flexibility - that is increasingly being followed by UK regional and national authorities. And it's the path being followed here in Wales by the National Assembly under First Minister Rhodri Morgan. It is the path that is being followed by the WDA and its subsidiary Finance Wales, as well as ELWa. If we know at the Bank about plant closures and job losses, we know, too, about NEDS (the Welsh National Economic Development Strategy) and we know about the new activity, creating new jobs, including, for example, Technium.

I said a moment ago that some of the current micro-economic problems are inevitable - a normal and necessary facet of economic progress. But the pressures we currently face go well beyond that. The effects of BSE and then of foot and mouth disease on agriculture, and the impact on the rural economy more generally, have been wholly abnormal. And the

pressures on the wider economy have recently been hugely aggravated by the international economic environment - first, by the persistent strength of sterling against the euro; then, by the global economic slowdown - including the dramatic contraction of activity in the previously booming high-tech sectors, and most recently by the vicious terrorist attacks in the United States.

With the best will in the world, there is nothing that we can do - certainly not through our domestic monetary policy - that goes to the causes of these problems.

That's obviously true in the case of the problems in agriculture.

Many people suppose that interest rates would have a predictable effect on exchange rates, but in fact it's not as simple as that. Many other factors influence exchange rates which can respond perversely to interest rate changes even for quite long periods of time. Despite the 4% cut in the US rates this year the dollar is still stronger against the euro - where rates have fallen by only 1% - than before the interest rate cuts started. And sterling, too, rose against the euro even though we cut interest rates earlier, and by more, than the ECB. The conundrum in fact has been the persistent relative weakness of the euro, since its introduction, and I very much welcome its modest recovery since the summer.

But on top of this exchange rate effect, external demand for goods and services produced in this country has been adversely affected by the unusual simultaneous slowdown in the world's three largest currency areas - the US, the Eurozone and Japan - that we have seen this year. And the terrorist attacks - with their inevitable effect on business and consumer confidence at least in the short term - could not have come at a worse time.

We can't, as I say, do anything directly ourselves to reduce the negative impact on the economy of these exogeneous shocks. What we can do is to try to compensate for them by encouraging the growth of domestic demand, and in particular consumer spending. And that in effect is what we have been trying to do through six cuts in interest rates so far this year, which have brought the mortgage rate, for example, to its lowest level for years. In the year to June final domestic demand grew by 3½%; but a fall in external demand helped to reduce the growth of total output to just over 2¼%. Overall UK manufacturing output in particular fell by 2% in the year to August, and while that is substantially less than the equivalent fall in Japan (of over 11%) and in the US (of 5½%), that's cold comfort to British industry.

The imbalance within the economy which these figures reflect - notably the continuing imbalance between the internationally-exposed companies and sectors, which are having a really rough time, and the domestically-orientated sectors which are doing much better - is certainly not ideal.

The continuing imbalance is not without risks. On the one side, we may find it increasingly difficult to offset the negative impact of the global slowdown in the face of increasing domestic private sector debt; and if the slowdown in the UK spreads beyond manufacturing to the services sectors it may cause unemployment to rise which in turn could slow the growth of consumer spending. But, on the other side, we may find it difficult to moderate the growth of domestic demand when the international environment improves.

There is no doubt that if we could simply redraw the map, we would opt for stronger external demand and weaker consumption growth. That would represent a more sustainable balance within our economy. Sadly that is a choice that we are not immediately free to make. Doing what we can to encourage domestic demand growth to compensate for the global economic weakness is certainly preferable to an unnecessary slowdown in the economy as a whole. And that is the path we must for the time being continue to pursue.

So what then are the prospects? Before the 11th of September the chances were that the US economy - which is of course key to the whole global outlook - was close to the bottom of its cyclical slowdown, and that we would see a gradual pick up into next year. The Eurozone, which is a particularly important trading partner for the UK, was also expected to recover lost momentum. That prospect may well have been set back by the terrorist attacks. These clearly had a direct impact on some sectors, including for example, air travel and the aerospace industry. And they had an effect on consumer and business confidence more generally. But the degree and duration of the set-back is very far from clear.

We need to be careful not to exaggerate the likely consequences. The effects on confidence, particularly consumer confidence, are already showing signs of abating; and global equity markets, although they remain volatile, quite quickly recovered much of their initial losses. Nor should we underestimate the swift and strong policy response both in the US and elsewhere. Looking further ahead it is difficult to see that the supply side of our economies has been materially affected: in particular the potential for modern technology to spread across different sectors, with the promise of improving productivity, remains intact, even if this is delayed by earlier excesses and by the more recent damage to business confidence. There is little reason that I can see to suppose that global growth will not recover to at least its earlier trend rate over the next 2-3 years once the immediate shock has been absorbed.

But in the meantime, the UK cannot be wholly immune from a more pronounced or prolonged global slowdown in the short term than we had previously expected - if that is indeed what occurs - even though we are better placed than some others to withstand it. Inflationary pressures remain well contained. Domestic demand appears to have been sustained into the third quarter, underpinned by increasing government spending in line with the Chancellor's intentions and by the easing of monetary policy. And consumer confidence in this country - on most of the evidence - seems to be holding up well despite the terrorist attacks. While business confidence generally weakened further in the third quarter, it remains stronger in the services sectors than in manufacturing. And on the basis of last week's BCC survey - it is notable that confidence in the services sectors here in Wales actually increased quite strongly.

No-one can know quite how things will turn out in the present climate of uncertainty. We cannot rule out a further slowdown here in the UK. But all-in-all I am still persuaded on the evidence that we will avoid the overall recession that is widely spoken of in the media - though it may be a bumpy ride for a time. But there is one thing of which you can be absolutely sure. And that is that the Monetary Policy Committee will continue to track all the evidence as it becomes available with the utmost attention; and if it suggests that the overall economy is weakening unnecessarily, so that overall demand is falling short of our supply-side capacity to meet that demand, with the implication that inflation will fall materially below the Government's symmetrical 2½% target, then we will not hesitate to ease monetary policy further try to reduce that effect. That is what we are required to do; and that is what we would anyway wish to do.

The corollary, of course, is that as and when external demand recovers, we will be equally vigilant in ensuring that domestic demand is reined back to accommodate it! But that may be now somewhat further ahead.