BANK OF ENGLAND

Speech

No Country is an Island

Speech given by
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"No Country is an Island"

No country is an island - in terms of economics, if not geography. Trade and capital flows link all the economies of the world. Since 1970 the volume of world trade has increased more than five-fold. Globalisation is not a slogan; it is a fact.

The economic winds can rapidly alter direction bringing significant changes in the economic weather. What happens in the world economy is of great importance to your industry. But no business in a country, such as the United Kingdom, which exports and imports almost a third of its national output each year, can ignore global economic developments.

Recent events have reminded us of just how volatile that economic weather can be. Only a few short months ago, the United States was experiencing rapid economic growth at a rate which surprised us all. The new frontier had become the new economy, and some had forgotten that economic downturns are a regular feature of a market economy. Share prices had reached levels four times that of a decade earlier, and the price earnings ratio of America's top 500 companies was over forty, an unprecedented level. Now, after a swift and sharp fall of business and consumer confidence, the business cycle appears to be alive and well, and living in the United States. Share prices have fallen by around 20% since their peak in March 2000; and technology stock prices have fallen even more, by 50%. Forecasts for economic growth in the United States for the coming year are still being revised down and are only one half of their levels of a few months ago.

Equally, only a few months ago, some currency traders were openly deriding the euro. The euro reached a low of 0.82 to the dollar - the lowest level for the euro or its antecedents for over 15 years. Since then, however, the euro has recovered, and the euro economy itself appears to be relatively stable. In the other major industrialised part of the world economy, Japan, output has barely risen in recent years. Real GDP in Japan has grown by only just over 1% a year over the past decade, compared with over 4% a year over the previous ten years.

Unexpected changes in the economic weather have also had a significant impact on the oil market. Oil prices rose from below $10 a barrel (for Brent crude) in December 1998 to a recent peak of over $37 last September, falling back to around $22 in December only to rise again to around $30 a barrel. The standard deviation of daily changes in oil prices rose by a factor of three from the first half of 1999 to the second half of last year: an indication of just how much volatility has risen.

Moreover, volatility has not been confined to the industrialised world. The past five years have seen a number of damaging financial crises that have afflicted emerging market economies. Sudden reversals of short-term capital flows to some of those economies resulted in crises that led not only to deep recessions and sometimes political crises, but also a renewed debate about the role of the IMF in providing bailouts to some of these countries.

Despite this volatility in international economic conditions the British economy, to date, has experienced greater stability. At first sight, this is encouraging. The UK has weathered some of the recent international economic storms, and achieved a post-war record of uninterrupted economic growth, falling unemployment, and inflation lower and more stable than for a generation. But no two storms are ever the same. Do the clouds on the international economic horizon threaten our economic stability at home? We cannot know. Rest assured that the Monetary Policy Committee will always act to maintain stability by keeping inflation on track to meet the target of 2½%. But the recent stability of inflation owes a good deal to the fact that economic shocks from overseas have tended to offset rather than reinforce each other. It would be rash to assume that it will be at all easy to keep inflation over the next five years within the 2%-3% range within which it has largely moved over the past five years. What matters most, however, is that any such deviations from target are short-lived, and that inflation expectations generally are firmly anchored on the target. If we cannot ensure that the waters are calm, we can at least steer a steady course.

I want tonight to look more closely at two clouds on the international economic horizon. First, the US slowdown and its consequences for the rest of us; and second, the risk of further financial crises in emerging market economies.

Central bankers are good at finding clouds. We know that one is attached to every silver lining. And even on passing through the gates of heaven, a central banker would probably argue for greater structural reform while declaring the situation "not wholly unsatisfactory". But the two clouds are moving towards us. So let us examine them.

The outlook for the world economy has deteriorated markedly in recent months as a result of the sudden slowdown in the United States and signs of renewed stagnation in Japan. The speed of the deterioration was a surprise, but not the fact of a slowdown. Last year saw the fastest growth rate of the world economy for twelve years. Growth in the US reached an annual rate of 6% in the second quarter of last year, well above even optimistic estimates of sustainable growth rates. A slowdown was not only inevitable; it was desirable.

The main surprise in the US was the sharp and sudden break in both business and consumer confidence. US manufacturers' optimism is now almost as low as it was in 1991 - the last time the US economy experienced a recession. Consumer confidence also fell sharply in January, driven by marked pessimism over the short-term future. Quite why this break in confidence should have been so rapid is not easy to understand. And its origins will largely determine the nature of the US downturn. On the one hand, greater use of information technology to economise on inventories may have led to shorter lags between changes in final demand and changes in output. If so, then it is possible that the speed of the downturn will be matched by the speed of the recovery, leading to a short-lived episode of output growth close to zero as the result of an inventory correction. On the other hand, the slowdown could be much more protracted if the imbalances in the US economy which have built up in recent years start to unwind, leading to a reduction in spending as both households and businesses seek to reduce the amount of outstanding debt on their balance sheets.

The key to the nature of the US downturn is what will happen to productivity growth. Over the past five years there has been accumulating evidence that the application of information technology has raised productivity growth in the US economy - the "new economy". Expectations of higher productivity growth increased demand by more than it raised supply initially, as firms invested in new technology and households anticipated higher future incomes. As a result, spending grew rapidly, outstripping supply and large imbalances emerged. The current account deficit in the US is now close to 5% of GDP, a post-war record. It is sustainable as long as foreigners are prepared to finance it. So far, the profitability of new investment opportunities in the US has attracted capital inflows to finance higher investment, which in turn has led to a strong dollar. If expectations about higher productivity growth prove well-founded, then US businesses and families will gradually repay the debts they have incurred, and the current account deficit will subside, with an adjustment of the dollar accordingly. Although the imbalances will unwind, they will do so slowly, allowing the US economy to recover from its present slowdown. But if there were to be a reappraisal of the extent to which productivity growth had increased, then a more sudden downward adjustment to spending could result. In such circumstances, the imbalances would unwind more rapidly, leading to adjustments in asset prices, both in stock markets and exchange rates. That would imply a much bumpier ride for both the United States and the world economy in the months ahead.

Clearly, there have been some downward adjustments to stock prices in the US over the past year. But their scale has been limited, and there does, at least so far, appear to be no significant reappraisal of the impact of new technology on US productivity growth. Although it is not easy to reconcile the recent sharp falls in confidence in the US and the relative stability of stock market prices, it would appear that investors generally have taken comfort from the Federal Reserve's ability and willingness to react to the latest data, and take appropriate action.

The second cloud on the horizon is the risk to emerging market economies posed by the US slowdown and the unwinding of imbalances in the industrialised world. In some emerging markets, especially those in East Asia exporting high technology products to the United States, the immediate outlook is for weaker economic growth. But for other countries, especially in Latin America, the fall in US interest rates and in the dollar against the euro will mitigate the direct loss of export demand.

But the major concern is to avoid another financial crisis, of which there have been too many in the past five years. From Mexico in 1995, through the Asian crisis in 1997 and Brazil in 1999, and, more recently in Argentina and Turkey, sudden reversals of short-term capital flows have created financial crises. In many cases, these crises have proved devastating to the citizens of the countries affected. The existence of deep and liquid international capital markets offers opportunities for greater risk diversification by both borrowers and lenders. But it also increases the risk of contagion from one country to another affected by an outflow of short-term debt finance.

There remains an urgent need for the international financial community to raise its game in both preventing and resolving such crises. On prevention, much has been achieved, built around the overriding principle of transparency. In itself, transparency will not prevent financial crises. But it can help reduce the frequency of crises - by alerting both markets and policy makers to problems on the horizon - and their severity - by minimising the surprises about the scale of any liquidity problems. On the resolution of crises, the past year has seen a significant change in practice with more weight given to the involvement of private sector creditors. The key to progress is the recognition that official finance from the IMF is strictly limited. Large bailouts from the IMF are undesirable - partly because they reduce the incentive for private sector investors to appraise carefully the risks they take, and partly because the funds available to the IMF are wholly inadequate for it to play the role of an international lender of last resort. Once it is recognised that official finance is limited, then it is clear that countries need to work closely with their own private sector creditors. Debt obligations must be honoured, although in some circumstances it may be necessary to restructure those obligations. The relationship between debtor countries and their private sector creditors is one that must be nurtured at all stages. And many emerging market economies have provided excellent examples of good relationships with their creditors, thus enabling them to raise new money or lengthen debt maturities at times of stress. The choice is not between large bailouts and no official finance. It is between an orderly framework, which recognises the complementary roles of private and official finance, and a disorderly process of default.

The combination of transparency to prevent crises and private sector involvement to resolve crises, follows naturally from the view that markets require information to work efficiently but that investors should take responsibility for the risks they choose to bear. This sentiment is remarkably close to views expressed recently by the new US Treasury Secretary. Now is the time to put in place a more systematic framework for the prevention and resolution of financial crises so that emerging market economies can take their rightful place in the international economy.

What do these clouds mean for the UK economy? Fortunately, our own imbalances are on a much smaller scale than those in the US. But here too, final domestic demand growth, which has averaged 4% a year for four years, has exceeded supply and the trade deficit has risen. Indeed, net trade is now likely to have made a negative contribution to output growth for five consecutive years, the longest such period since the nineteenth century. Final domestic demand growth, and especially that of private consumption, needs to slow. Nevertheless, the differences between recent developments in the UK and the US are more significant than the similarities. Perhaps the most striking difference between the US and UK economies has been the remarkable resilience of business and consumer confidence in the UK in recent months. Of course, further weakness of the world economy, emanating perhaps in emerging markets, could change the outlook.

Nevertheless, Mr President, I am confident that the British economy can withstand the storms and vicissitudes of the international economic weather. But it is in the interests of all of us to work to ensure a prosperous international economy. No country is an island. As John Donne expressed the thought so vividly in his aptly-named *Devotions upon Emergent Occasions* "all mankind is of one author, and is one volume."