BANK OF ENGLAND

Speech

Speech given by

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

At the Asian Business Association Dinner, London

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Thank you, Mr President, for that kind introduction. I'm delighted to be here.

In fact it's the second time this year that I've had the pleasure of dining with representatives of the Asian Business Community in the UK.

Just a couple of months ago, in Glasgow, I joined the Association of Business Community in paying tribute to Mr Yaqub Ali for the remarkable contribution that he has made to Scottish commercial and community life since he arrived here from Pakistan some 50 years ago.

It was a very poignant occasion, coming as it did when the terrorist attacks of 11th September in New York and Washington were still fresh in our minds. Those events sadly have been sometimes represented – or misrepresented – as having something to do with ethnic or religious differences.

But, as the universal condemnation of terrorism which followed the events of 11th September showed, they had nothing to do with ethnic or religious differences; they were a reflection of a fanaticism which has no place in any civilised society. Nevertheless they clearly had the capacity to accentuate perceived differences, and to provoke unwanted tensions within our international, national and local communities.

The contrast between this concern and the example and experience of Mr Ali, which we celebrated that evening in Glasgow, could not have been more pronounced. Whatever the difficulties he faced – of social disadvantage, and no doubt, too, of some degree of ethnic prejudice in the UK – Mr Ali overcame them. From modest beginnings, he moved on to build a whole series of substantial businesses not simply to his own benefit but to the great benefit, in terms of both the goods and services, and the income and employment which he provided to the community which adopted him. But, beyond this impressive business achievement, he also made a great contribution in terms of community service and charitable involvement both here in the UK and in relation to Pakistan.

Now this example of the contribution that ethnic minority business – given the proper opportunity and encouragement – can make to our economy is certainly not unique.

The Bank of England's investigation some 18 months ago into the availability of finance to ethnic minority firms suggested that while the ethnic minorities represent some 5% of the UK population, they controlled some 7% of UK businesses and accounted for around 9% of new business start-ups. Those national figures relate to 1997, so they are a little out of date. But more recent figures from the London Chamber's report, published last December, on the contribution of Asian business to London's economy, suggest that the ethnic minority population manages or owns some 20% of London's private sector businesses, with the Asian community alone accounting for half that – or some 10% of the total. These figures make a powerful point, which is underlined by the presence of so many Asian and non-Asian business and professional people here this evening.

They illustrate very vividly the great benefit that can accrue to our society, as a whole, from providing the opportunity to all the people in the UK, whatever their background, to realise their full potential and achieve all that they can in their different fields. It underscores the importance of non-discrimination, whether ethnic or religious, sexual or social, to the material as well as the moral progress of our whole community. It is a real pleasure to be with you.

In his letter of invitation to me, your Chairman – Subhash Thakrar – suggested that I could talk about anything I wanted to this evening, provided it was the state of the economy, and provided I tell you what precisely will happen to interest rates. Let me begin by trying to explain to you what we at the Bank – through the MPC – are tasked to do, and why.

The task sounds straightforward. It is to set short-term interest rates with the consistent aim of hitting the Government's symmetrical 2½% inflation target (on a precisely defined measure of retail price inflation – RPIX). Now the reason we've been set that task is not – as some people imagine – because either we or the Government think that consistently low inflation is the be all and end all of economic life. It is because we've learned from long experience that consistently low inflation is a necessary (though not in itself sufficient) condition for the sustained growth of output of the economy as a whole, for high levels of employment, and for rising living standards, which are, of course, more fundamentally the things that we are all seeking to achieve.

Carrying out our task is not as straightforward as it sounds because there is no simple, direct, link between short-term interest rates – the only instrument we have - and the rate of inflation.

Interest rates essentially affect the demand side of the economy. They don't directly influence the supply side, which depends upon a whole host of structural characteristics which are largely beyond the direct reach of monetary policy. What we have to do in managing short-term interest rates is to keep overall demand growing broadly in line with the underlying – sustainable – supply-side capacity of the economy as a whole to meet that demand. In other words we are trying to maintain overall, macro-economic, stability in a much broader sense, in the medium– and longer– term and not just the short-term; and the Government's inflation target is the criterion against which our success, or otherwise, in achieving that broader macro-economic stability is to be measured.

Our problem is that we don't know with any great precision or confidence exactly what is happening on the supply-side:– we don't know that's to say precisely what rate of growth we can hope to sustain. We don't know precisely either what is currently happening, or what is likely to happen looking forward over the next couple of years or so, to overall, aggregate, demand. And nor do we know precisely what the full impact of a change in interest rates will be on aggregate demand, or how long it will take before the full impact is felt.

Ours is not a precise science. In fact it's more of an art than a science. And, although we bring as much economic and statistical science to bear as we can, we know that our forecasts, and indeed our policy judgements, are subject to a range of error. They can't be accurate to every last digit. So, we can't expect to hit the inflation target all the time, but by consistently aiming to do so we can hope to get reasonably close to the target on average over time.

The uncertainties are well illustrated by the sudden jump in the RPIX inflation rate in January to 2.6% announced a month ago, only to fall back to 2.2% in February – published this morning. And, given these uncertainties, the overall results over the past decade since the recession of the early 1990's have been encouraging. Whether that's a result of good luck or good judgement I leave to others to decide – I'm more interested in the outcome.

Since the Summer of 1992, inflation, on the target measure has averaged just 2.6% - and has been more stable than at any time in our history. And it has been consistently remarkably close to target over the past 5 years.

But the even better news is that stable, low, inflation has been accompanied by steadily increasing overall output and employment, and by a progressive fall, until very recently at least, in the rate of unemployment.

Over the same period, to the fourth quarter of last year, GDP growth averaged just under 3% a year – which is well above most estimates of our trend rate of 2¼%-2½%. GDP has in fact grown for 38 successive quarters which is the longest period of sustained quarter–by-quarter growth we have enjoyed since quarterly records began in the UK in 1955 – though I have to admit it was a close run thing in the fourth quarter of last year!

Employment has increased steadily from a low point of 25 ½ mn people – and we are taking people here, not just statistics - in the Spring of 1993 to its current level of around 28 mn. And the rate of unemployment fell from a peak of over 10½% on the internationally comparable LFS measure to around 5% last summer; while on the claimant count measure it fell from some 10% to just over 3%, which meant that the number of people claiming unemployment benefit, at under 950,000, was the lowest for 26 years.

Now some of you – given what's happening in your own businesses – are probably thinking that I must live on a different planet. And yes, we do have a problem. Once you look beneath this apparently benign surface of the economy as a whole, you find very substantial differences between many internationally-exposed sectors of the economy – including particularly many manufacturing businesses – which have recently been having a really tough time, and other businesses largely serving our domestic market which have generally been doing very much better.

There are two main reasons for the pressures affecting the internationally-exposed sectors: the synchronised economic slowdown over the past year or so in all major industrial countries, on the one hand; and the puzzling and persistent weakness of the euro in foreign exchange markets not just against sterling but even more against the dollar, on the other.

The frustrating thing is that, with the best will in the world, there was not much that either we at the Bank or the UK Government could have done to ward off the pressures on UK manufacturing, which had their origins abroad.

It's fairly obvious where we are talking about the global slowdown – with negative growth last year of about ½ % in Japan and very slow growth of just 1¼ % in the US and 1½% in the Eurozone. We can go to international meetings and encourage the respective authorities there to stimulate their economies, but there is nothing that we can do about it directly ourselves.

It's perhaps less obvious that we cannot influence the exchange rate. Many people think that we could weaken sterling against the euro quite simply by cutting our interest rate relative to the interest rate in the eurozone. But it's not as simple as that. The US has reduced its interest rate far more aggressively than the ECB over the past year or so, but the dollar is actually stronger against the euro than it was to begin with; and the same is true, to a lesser degree, of ourselves, here in the UK, with sterling also stronger against the euro (though weaker against the dollar) than it was a year ago.

So there was nothing much – as I say – that we could have done directly to affect these depressing effects coming from the global economy and the resulting weakness of external demand on the UK.

But what we were able to do – given that inflation was marginally below target – was to try to compensate for that external weakness by stimulating domestic demand here in the UK. The Bank sought to do this by cutting interest rates to buoy up consumer spending. And the Government has stepped up its own spending, which was certainly helpful in the recent international environment. Although we couldn't avoid an overall slowdown altogether we did manage to keep the UK economy as a whole moving forward despite the recession in the internationally-exposed sectors of manufacturing.

In fact overall GDP growth in 2001, at 2.4%, was by some margin, the highest among the G7 countries, and the rate of UK unemployment is currently the lowest, on a comparable basis, in the G7. And interest rates are, as I said, the lowest they've been in this country in a generation.

Of course we'd all have been much happier with better balanced growth. Stimulating domestic demand to offset the external weakness – the only option available to us – was very much a second best option, and not without its own risks, but it was better than doing nothing at all. That would have meant a much sharper slowdown, and probably recession, in the economy as a whole. And, given the fact that inflationary pressure remained subdued, it would have meant a quite unnecessary loss of overall output – and income and employment. In effect we took the view that unbalanced growth was better than no growth.

The question now, of course, is where do we go from here.

There have recently been encouraging, but still tentative, signs that the worst of the global slowdown may now be behind us, and that the US and Eurozone economies are now beginning to bottom out and will pick up, perhaps to around trend, as we go through this year. Some Asian countries actively involved in the ICT sector are showing a strong recovery, and even in Japan financial markets have recently strengthened. As for the exchange rate, the euro, which has, as I say, been puzzlingly weak since soon after its introduction 3 years ago, still seems likely to strengthen eventually. As it becomes clearer that the international environment really is improving, and that external demand really is picking up, then we can look forward to better balanced and generally stronger growth in our own economy.

That will in due course mean that domestic demand growth – and consumer demand growth in particular – will need to moderate if we are to avoid a build up of inflationary pressure. But let me be quite clear – that's not a warning, still less is it a threat. It is essentially just a matter of arithmetic! It's quite possible, even quite likely, that the necessary moderation of consumer demand – and I emphasise the word moderation – will come about of its own accord, given the gradual increase in unemployment we are currently seeing, and the build up of household debt. And provided it does not happen too abruptly, that would be the best possible outcome. But if consumer spending were not to moderate of its own accord, we would, in the context of strengthening external demand, clearly need at some point to consider raising interest rates to bring that moderation about. I don't suggest that the timing of any such move is imminent – that will obviously depend upon the timing and the strength of the recovery abroad and on the strength of domestic demand as we move forward.

And that, Subhash, is of course my answer to your second question – "what precisely will happen to interest rates?" In case any of you are confused, I think that what I said was that interest rates will rise – unless they fall or stay the same!

Mr President, there is no doubt that the past year or so has been a difficult time for the world economy which made life increasingly difficult for the internationally-exposed sectors of our own economy. We are not yet altogether out of the wood, but there is increasing light between the trees. I am "cautiously optimistic" that the overseas environment will improve as we move through 2002, and that by this time next year we here in the UK will have seen a return to somewhat stronger and better balanced growth, with unemployment not far above its recent lows, and with continuing low inflation. If that is indeed how things turn out, we will have weathered the international storm as well as anyone could reasonably have expected.

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